

# ANNUAL PERFORMANCE REPORT FISCAL YEAR 2004



FEDERAL  
STUDENT AID

*We Help Put America Through School*



# TABLE OF CONTENTS

<b>A Message from the Chief Operating Officer</b>	1
<b>FSA at a Glance</b>	3
Introduction	3
Mission	3
Organization	4
Programs	5
<b>FY 2004 Performance Highlights</b>	9
Objective 1: <i>Integrate FSA Systems and Provide New                     Technology Solutions</i>	10
Objective 2: <i>Improve Program Integrity</i>	13
Objective 3: <i>Reduce Program Administration Costs</i>	20
Objective 4: <i>Improve Human Capital Management</i>	23
Objective 5: <i>Improve Products and Services to Provide Better                     Customer Service</i>	26
Objective 6: <i>Deliver Student Aid Effectively and Accurately</i>	32

---

## **Appendix A – FY 2004 Financial Statements**

- Letter from FSA CFO
- Financial Discussion and Analysis
- Principal Financial Statements

## **Appendix B – Independent Auditors Report**

- Report of Independent Auditors
- Report on Internal Control
- Report on Compliance with Laws and Regulations

## **Appendix C – Performance Data Tables**



## MESSAGE FROM THE CHIEF OPERATING OFFICER

Education is more important today than at any other time in history. To meet the demands of a global, high-tech marketplace, employers require a diverse pool of highly trained candidates to fill increasingly complex positions. Students are taking note of these workforce changes and enrolling in higher education and technical training programs at record rates. Professional, middle-aged people are returning to the classroom in greater numbers to take advantage of the opportunities presented by a continuing education. The result is the most educated and competitive workforce in our history.

At the Department of Education's Federal Student Aid (FSA) office, we help America tap this fundamental resource by providing the financial assistance necessary for college-bound students and their families. **We Help Put America Through School** by providing the right aid to the right student at the right time.

In FY 2004, FSA's 1,100 employees helped disburse more than \$69 billion in aid to more than 10 million students and families attending over 6,200 schools. FSA also managed an outstanding loan portfolio of \$357 billion. In addition to effectively and efficiently running its operations, FSA made significant progress in meeting the goals and objectives of the performance-based organization (PBO) legislation including improving customer service, enhancing program integrity, and pursuing systems integration and cost reduction initiatives to ensure access to postsecondary education while reducing the vulnerability of student aid programs to fraud, waste, error, and mismanagement.

FSA's accomplishments contributed to the Department of Education's achievement of "green" status on the President's Management Agenda (PMA) financial management initiative and enabled FSA to move to "green" on progress on the PMA initiative related to eliminating fraud and error in the student aid programs and deficiencies in financial management.

In FY 2005, FSA will deliver more aid to more students at lower cost than ever before. FSA's oversight responsibilities will continue to be firm and fair, extending beyond the families who benefit from our assistance to the colleges, universities, and career schools that participate in our programs and the financial institutions and other program participants that support us in our efforts. Operationally, FSA will continue to implement processes and procedures to ensure the effective and efficient delivery of student aid while reducing the incidence of waste, fraud, and abuse.

Additionally, we believe FSA's sustained and meaningful progress in improving financial integrity and management exceeds the Government Accountability Office (GAO) criteria for removal of the high-risk designation from the federal student aid programs. I am confident of our progress in addressing GAO's concerns and look forward to favorable consideration and removal of the federal student aid programs' high-risk designation when GAO issues an updated High-Risk Series.

In closing, I want to acknowledge the unwavering commitment and dedication of FSA's employees. Collectively, they are our organization's single greatest asset and the foundation of our success. I am honored to represent them in presenting this report of our accomplishments for the past year.

Education is our nation's highest priority. At FSA, we will continue to work tirelessly to raise awareness of the benefits of a postsecondary education, increase access to institutions of higher education, and earn the trust bestowed upon us by the American people.



*Theresa S. Shaw,  
Chief Operating Officer,  
Federal Student Aid*

A handwritten signature in black ink, appearing to read "Theresa S. Shaw".

Theresa S. Shaw







# FSA AT A GLANCE

## INTRODUCTION

In FY 2004, the Department of Education's Federal Student Aid (FSA) office delivered superior customer service, developed award-winning products and services, and provided fair and effective oversight in the management of the Title IV programs. This report presents a summary of FSA's mission, programs, and accomplishments. We have included specific references from FSA's Five-Year Strategic Plan to illustrate how our short-term goals and achievements are aligned with our long-term objectives. Appendix A provides Financial Discussion and Analysis of FSA's financial results. Appendix B provides the results of FSA's performance measures for FY 2004.



## MISSION

At FSA, *We Help Put America Through School* by delivering the right aid to the right student at the right time in the right way. Through our public outreach initiatives and strengthened by established relationships with student groups, schools, lending institutions, and guaranty agencies, we help students and their families plan and pay for higher education. Our federal grant and loan programs represent the largest sources of student aid in the United States, annually providing approximately \$69 billion<sup>1</sup> to almost 10 million students attending approximately 6,200 schools. Many of these students may not otherwise have access to education beyond high school.



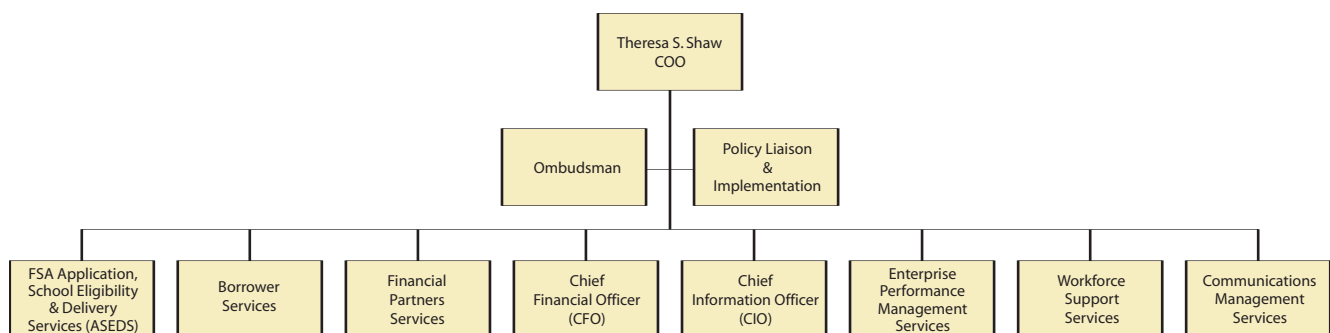
<sup>1</sup>Excludes consolidation loans of approximately \$32 billion.

## ORGANIZATION

The Secretary of Education appoints FSA's senior executive, the Chief Operating Officer (COO), to a five-year term. This appointment is made on the basis of demonstrated management ability and expertise in business process re-engineering, student aid delivery and servicing operations, large-scale technology rollout and integration, system implementations and upgrades, vendor and contract management, budgeting and cost control, and financial and operational management. The current COO is Ms. Theresa S. Shaw.

FSA's organization is aligned with FSA's strategic drivers, business objectives, operational goals, and, most importantly, its customers. This structure provides an effective and efficient operational organization that delivers student financial assistance and manages the inherent risks of the programs. Figure 1 describes FSA's organization.

**Figure 1 – FSA Organization**

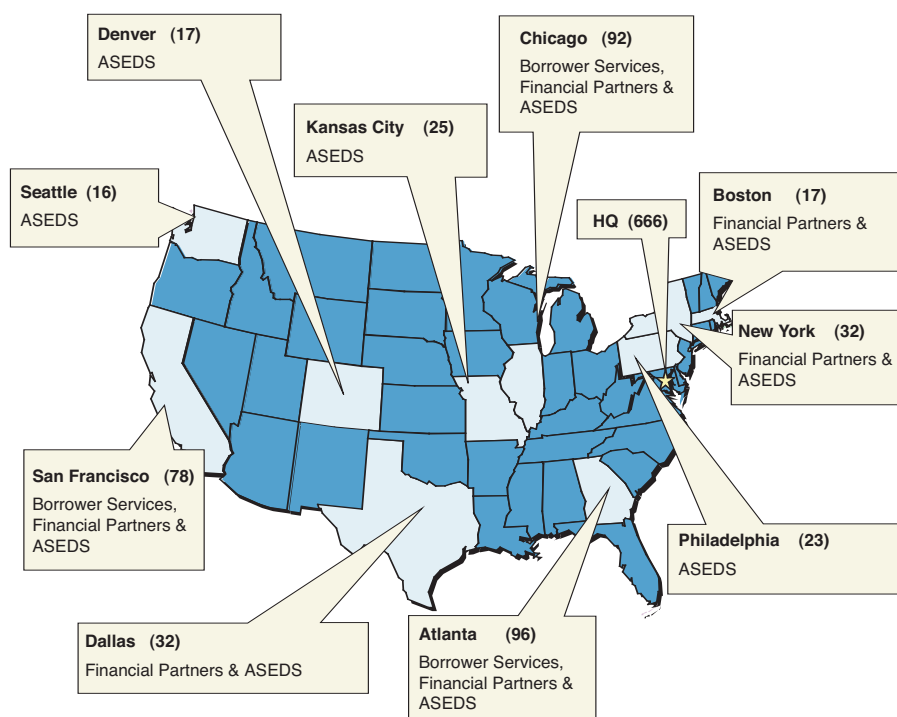


To carry out its responsibilities, FSA has an annual administrative budget of approximately \$621 million. This amount does not include funding used to collect defaulted loans, to pay account maintenance fees to guaranty agencies (GAs), and to consolidate loans into the Direct Loan Program. FSA has a staff of nearly 1,100, augmented by contractor support that provides outsourced business operations. Together, these staff and contractors operate and maintain the many systems and processes used by FSA to manage the federal student aid programs. FSA employees are located throughout the country, primarily in Washington, D.C. headquarters (HQ), and in ten Department of



Education Regional Offices. The states in which there is a regional office are represented by light blue on the map in Figure 2; the number in parentheses represents the number of FSA employees in each region; and, “ASEDS” represents the Application, School Eligibility, and Delivery Services.

**Figure 2 – FSA Regional Map**

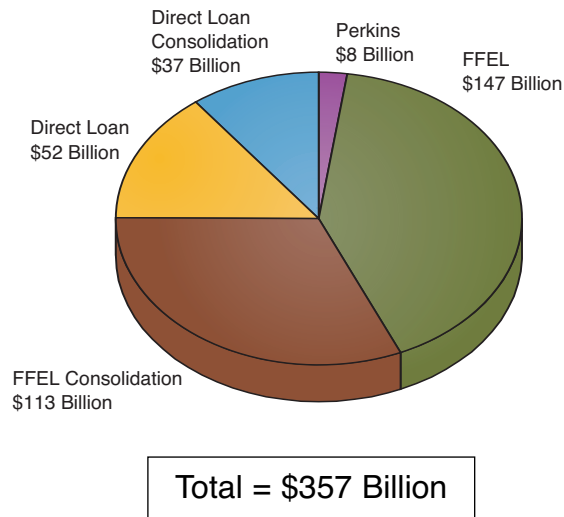


## PROGRAMS

FSA manages and administers postsecondary student financial assistance programs, authorized under Title IV of the Higher Education Act (HEA) of 1965, as amended. These programs include the Federal Pell Grant Program, the William D. Ford Federal Direct Loan Program, the Federal Family Education Loan (FFEL) Program, the Federal Supplemental Educational Opportunity Grant (FSEOG) Program, the Federal Perkins Loan Program, the Federal Work-Study (FWS) Programs, and the Leveraging Educational Assistance Partnership and Special Leveraging Educational Assistance Partnership (LEAP/SLEAP) Program. In addition, FSA directly manages or oversees approximately \$357 billion in outstanding student and parent loans for more than 25 million borrowers.



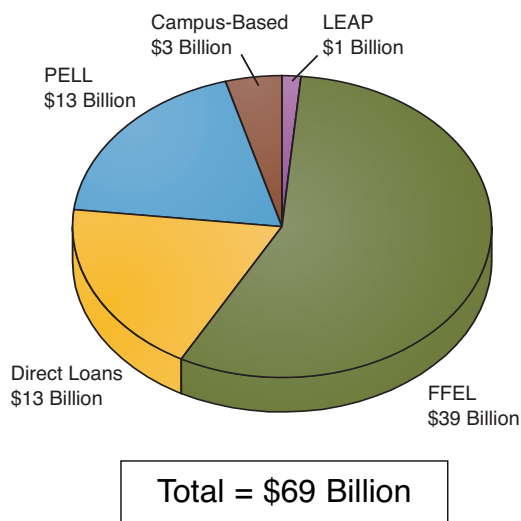
**Figure 3**  
**FSA Student Loan Portfolio**



In 2004, FSA delivered or facilitated the disbursement of approximately \$69 billion in federal student aid to about 10 million postsecondary students and their families. FSA works with approximately 6,200 schools, more than 3,400 lenders, 36 GAs, and dozens of accrediting agencies as well as secondary markets, third-party servicers, and other entities including state grant agencies.

The following paragraphs briefly describe each of the major federal student aid programs.

**FY2004 New Student Aid**



The **Federal Pell Grant Program**, the most need-focused of the federal student aid programs, helps ensure access to postsecondary education by providing grant aid to low and middle-income undergraduate students. For the 2003–2004 award year, FSA disbursed \$12.7 billion in Pell Grants averaging \$2,467 to 5.1 million students. The maximum Pell Grant award amount increased from \$4,000 for the 2002–2003 award year to \$4,050 for 2003–2004.

The **Direct Loan Program** lends funds through participating schools directly to students. The Department borrows these funds from the U.S.



Treasury. In FY 2004, the Department awarded \$13.2 billion<sup>2</sup> in net loans to 1.9 million Direct Loan Program recipients. The average subsidized Direct Stafford Loan was \$3,674, while the average unsubsidized loan was \$4,199.

Funds for the **Federal Family Education Loan (FFEL) Program** are provided by private lenders, although the loans are insured by GAs and re-insured by the federal government. During FY 2004, FSA facilitated the delivery of \$39 billion<sup>3</sup> of loans to 5.4 million FFEL recipients. The average subsidized FFEL Stafford loan was \$3,435, while the average unsubsidized FFEL Stafford loan was \$4,239. In addition, FSA paid an estimated \$3.0 billion to lenders for interest and special allowance subsidies, and an estimated \$3.9 billion for re-insurance, loan processing and issuance fees, and account maintenance fees required by the HEA.



The three **Campus-Based Programs** — the FSEOG Program, the Federal Perkins Loan Program, and the Federal Work-Study Program — provide funds to institutions that enable them to provide grants, low-interest loans and employment to students. For the 2003–2004 award year, approximately \$3.4 billion of campus-based funding was disbursed to approximately three million recipients. Matching requirements provide additional funding for these programs.

The **LEAP/SLEAP Program** makes federal funds available to assist states in providing grant assistance for students with “substantial financial need.” For the 2003–2004 award year, approximately \$65 million was disbursed to states serving approximately 1.2 million recipients. This program also has matching requirements that provided an additional \$896 million in funding, bringing the program’s total to approximately \$1 billion.



<sup>2</sup> Excludes consolidation loans of \$6.3 billion.

<sup>3</sup> Excludes consolidation loans of \$25.6 billion.



# FY 2004

## PERFORMANCE HIGHLIGHTS

FSA has realized considerable progress in administering the federal student aid programs since it became the federal government's first PBO in 1998. To more effectively manage the programs and to provide clear strategic direction to all internal and external constituencies, FSA's Chief Operating Officer and senior leadership team identified six strategic objectives to guide the organization. These are:

- Integrate FSA systems and provide new technology solutions to deliver federal student aid in an efficient and cost-effective manner;
- Improve program integrity to ensure access to postsecondary education while reducing vulnerability to fraud, waste, and abuse;
- Reduce program administration costs to improve control over resources and maintain accountability for results;
- Improve human capital management;
- Improve products and services to provide better customer service; and
- Deliver student aid effectively and accurately.



In FY 2004, FSA achieved considerable progress in meeting these objectives. The following sections detail FSA's FY 2004 accomplishments.





## OBJECTIVE 1: INTEGRATE FSA SYSTEMS AND PROVIDE NEW TECHNOLOGY SOLUTIONS

---

*FSA will improve efficiency and productivity, reduce system maintenance and overhead costs, and increase the operating ease for users of FSA's systems. FSA will continue to provide appropriate and integrated technology solutions that enable the delivery of federal student aid in an efficient and cost effective manner. In addition, FSA will establish a plan to take advantage of new technologies to improve application processing, customer service, productivity, and efficiency.*

*FSA's 5-Year Strategic Plan*

---

In FY 2004, FSA continued implementation of a multi-year sequencing plan for system and business process integration. Several key initiatives were introduced including the Common Services for Borrowers (CSB) initiative, which will re-engineer FSA's back-office loan servicing, Direct Loan consolidation, and defaulted loan collection processes, saving America's taxpayers an estimated \$1 billion over the life of the contract. Similarly, FSA initiated the re-engineering of its aid awareness, application and disbursement business processes and systems with the launch of our Front-End Business Integration (FEBI) project. In addition, FSA is teaming with the Department to implement Oracle Federal Financial Release 11i, a project to consolidate the Department's financial management into a single solution called OneFinancial. FSA also began to integrate the data it receives from schools, lenders, GAs, and servicers through the Integrated Partner



Management (IPM) project. All of these initiatives are supported by FSA's Enterprise Data Strategy project that began in 2003. The Enterprise Data Strategy will ensure accurate and consistent data is exchanged among all of FSA's business partners. Each of these major initiatives will continue through 2005 in accordance with the established project plans for each and within the defined sequencing plan for FSA's system and business process integration.



### ***COMMON SERVICES FOR BORROWERS (CSB)***

In FY 2004, FSA awarded the CSB contract, a project that consolidates four major business processes — Direct Loan Servicing, Default Collections, Direct Loan Consolidation, and Total and Permanent Disability Discharge — into a single integrated system solution while consolidating multiple data repositories into a single data source. In addition to improving borrower benefits, the CSB re-engineering effort is expected to save an estimated \$1 billion over the potential 10-year contract term.

FSA began the new CSB contract in FY 2004, under which legacy services are provided as the development of the new CSB platform is underway, resulting in an immediate savings of \$21 million. Additionally, system development efforts were completed, replacing both the Credit Management and Direct Loan Data Marts with a single data source for all Direct Loan and defaulted borrower account information.

During FY 2005, the phased implementation of CSB will continue, beginning with Direct Loan Consolidation functions, with the remaining three business processes to be completed by the end of the year.

### ***IMPROVED STUDENT DELIVERY SYSTEMS***

---

*The fragmented front-end business processes and systems of FSA complicate the delivery of federal student aid for applicants and their parents as well as for borrowers, schools, and delivery partners. The lack of integration of information, processes, and their support systems impairs the delivery of services for FSA employees and operating partners. FSA will address this problem in FY 2004 by initiating the creation of an enterprise-wide, integrated, front-end delivery service.*

*FSA's 5-Year Strategic Plan*

---

In FY 2004, FSA initiated the FEBI project to create an enterprise-wide, integrated delivery system. The FEBI solution will consolidate the following business processes into a single solution: Free





Application for Federal Student Aid (FAFSA) application processing; Pell Grant and Direct Loan origination and disbursement; customer service support; and publication development services. These business processes are supported by four legacy system contracts: Central Processing System (CPS), Common Origination and Disbursement (COD), Public Inquiry Call Center, and Editorial Services. These contracts are nearing the end of their respective terms and will be replaced through this procurement with a contractual solution designed to achieve maximum business efficiencies, improve customer service, and deliver cost savings.

FY 2004 was devoted to defining the scope of the initiative, conducting market research and industry benchmarking, and surveying vendors' ability to provide feasible solutions. FSA is currently in the final stages of the procurement process for FEBI and anticipates awarding a performance-based contract in FY 2005.

### **ONEFINANCIAL**

Teaming with the Department's Office of the Chief Financial Officer, FSA is implementing a new financial management solution on the Oracle 11i platform. The implementation of OneFinancial is intended to strengthen internal controls and financial management across the Department, including FSA. In FY 2004, high-level planning and a detailed requirements definition were begun, including the completion of one of three pilots designed to be proof-of-concepts for the desired configurations and requirements of the new solution. The remaining pilots, detailed requirements, testing, and validation, as well as the migration of data to the new platform, will be completed in FY 2005 in anticipation of an implementation and "live" date of October 1, 2006.



## **INTEGRATED PARTNER MANAGEMENT (IPM)**

Another key integration initiative that began in FY 2004 is the IPM solution. This project integrates data from FSA partners — schools, lenders, GAs, and servicers — to enhance FSA's oversight activities as well as provide these partners with a single point of entry to FSA's systems environment. Currently, there are multiple points of entry, multiple IDs, and multiple passwords required for business partners to conduct business with FSA. In addition to completing the high-level business definition of the current and target states, FSA has completed the initial design for both the common identifier and access and enrollment management.

## **ENTERPRISE DATA STRATEGY**

---

*Data strategy will ensure that accurate and consistent data is exchanged between FSA's systems and its employees, customers, and partners as well as compliance and oversight organizations.*

*FSA's 5-Year Strategic Plan*

---

In FY 2004, FSA completed Phase II of the Data Strategy project. During this phase an enterprise-wide target state vision was established. This vision is being used to develop a common data architecture to integrate FSA's major systems going forward including CSB, FEBI, IPM, and the planned re-engineering of the National Student Loan Data System (NSLDS) that will begin in FY 2006.

## **OBJECTIVE 2: IMPROVE PROGRAM INTEGRITY**

---

*FSA will ensure that aid under the federal student aid programs is delivered directly by FSA and through school, lender, and guarantor participants in a manner that reduces the vulnerability of these programs to fraud, waste, error, and mismanagement. FSA is continually working to improve program integrity and is committed to demonstrating responsible management of the programs targeted for removal from the GAO High-Risk List.*

*FSA's 5-Year Strategic Plan*

---



Program integrity continues to be a top priority for FSA including implementing and enhancing sound financial management controls, comprehensive program participant (schools, lenders, GAs, etc.) oversight, and focused default prevention initiatives. In FY 2004, FSA achieved its third consecutive unqualified audit opinion on its financial statements with no material internal control weaknesses noted for the second straight year. FSA focused on key management issues identified by the GAO and initiated an identity theft awareness project. Working closely with the higher education community, FSA developed comprehensive outreach initiatives to educate student loan borrowers about their repayment responsibilities resulting in the lowest Cohort Default Rate in history. In FY 2004, FSA established an enterprise risk management function to develop risk assessments, provide a more strategic view of downstream risk potentials, and better equip senior management to anticipate, analyze, and manage risks inherent to the federal student aid programs. In FY 2005, FSA will develop this function as a core competency for the organization, instilling risk management best practices across the enterprise. This includes a partnership with the Office of the Inspector General (OIG) to identify and address risks in the federal student aid programs and to work with other agencies and organizations to identify additional areas for improvement.



### ***SOUND FINANCIAL MANAGEMENT***

---

*FSA's efforts to improve program integrity include the ongoing strengthening of its financial management and internal controls so that reliable and timely information is available to FSA's management for critical day-to-day business operations.*

*FSA's 5-Year Strategic Plan*

---

One of the Department of Education and FSA's most significant accomplishments is the receipt of three consecutive unqualified audit opinions on their financial statements. In addition, in FY 2003 and FY 2004, FSA eliminated all material internal control weaknesses. To ensure clean audit opinions in subsequent years, FSA institutionalized sound financial management and internal controls at every level within the organization. Additionally, FSA's accomplishments contributed to the





Department of Education's achievement of "green" status on the PMA financial management initiative and enabled FSA to move to "green" on progress on the PMA initiative related to eliminating fraud and error in student aid programs and deficiencies in financial management.

### **REMOVAL FROM THE GAO HIGH-RISK LIST**

---

*In FY 2004, and in every subsequent year of the 5-Year Plan, FSA will carry out its program to ensure that sustainable internal controls, system support, and management focus are in place and to demonstrate that the federal student aid programs are administered through sound financial management and oversight.*

---

*FSA's 5-Year Strategic Plan*

---

GAO has designated the federal student aid programs as "high-risk" since 1990 due to their vulnerability to fraud, waste, abuse, and mismanagement. The Secretary of Education and FSA management are committed to removing the student aid programs from GAO's High-Risk list and as such have implemented an aggressive plan to focus on the issues GAO identified. In FY 2004, FSA conducted a series of in-depth briefings for GAO to showcase FSA's progress in developing and implementing comprehensive monitoring and validation procedures, demonstrating strong commitment and senior-level leadership support for addressing issues and risks and ensuring proper capacity in terms of staff and resources. In October 2004, GAO issued a report recognizing FSA's significant progress in resolving financial integrity and management issues and sustained improvements in the administration of the student financial aid programs. FSA anticipates removal of its programs from the high-risk list in January 2005.

### **PROGRAM MONITORING AND OVERSIGHT**

---

*For FY 2005-2008, FSA will continue to improve program reviews, to improve reporting capabilities on audit findings, to enhance collaboration with OIG to identify and address risks in the federal student aid programs, and to work with other agencies and organizations to identify additional areas for improvement.*

---

*FSA's 5-Year Strategic Plan*

---



During FY 2004, FSA continued to enhance its program integrity efforts to reduce the vulnerability of student aid programs to fraud, waste, error, and mismanagement while ensuring access to post-secondary education. Specifically, school oversight in FY 2004 included the following key activities:

- Evaluated 100 percent of schools through review of financial statements, compliance audits, and cohort default rates;
- Performed comprehensive reviews (including on-site, off-site, and records review) of 2,760 schools (44.7 percent).

Currently, there are 1,161 schools on provisional certification, 460 schools that have submitted a letter of credit, and 285 schools on heightened monitoring of cash disbursements. In addition to these specific oversight activities, FSA improved its program integrity efforts by enhancing its internal procedures for performing compliance reviews and providing technical program assistance for schools.

FSA also continued to improve its internal procedures and management controls relating to GAs, lenders, and loan servicers participating in the FFEL Program. This included additional focus on the frequency and level of compliance reviews, the proper and consistent reporting by GAs, an analysis of GA reserve ratios under four different methodologies, and the continued evolution of risk assessment and monitoring tools. Specifically, financial partner oversight in FY 2004 included the following key activities:

- Reviewed 100 percent of GA financial statements audits;
- Reviewed 251 lender and third-party servicer financial statement audits;
- Performed program reviews of 598 lenders, 19 GAs, and 18 third-party servicers; and
- Collaborated with GAs to complete reviews of 174 lenders.

In FY 2004, FSA completed an analysis of costs associated with existing Voluntary Flexible Agreements (VFAs) with American Student Assistance (ASA), California Student Aid Commission (CSAC), Great Lakes Higher Education Guaranty Corporation (Great Lakes), and Texas Guaranteed Student Loan Corporation (TG). The results of this analysis are the basis for evaluating new



applications for VFAs. VFAs incorporate and modify the existing FFEL Program agreements between the Department and the participating GAs in order to test new and innovative methods for carrying out the types of activities currently required of GAs. College Access Network (formerly Colorado Student Loan Program) joined the VFA program in FY 2004.

GAs and GA servicers designated for exceptional performance receive 100 percent re-insurance on all claims submitted for payments during its period of designation. A lender or lender servicer designated for exceptional performance is eligible to receive 100 percent reimbursement on all claims submitted for insurance during its period of designation (twelve months). In FY 2004, FSA granted Exceptional Performer status to the following:

- Citibank SLC;
- Wells Fargo- Education Financial Services;
- CFS – SunTech Servicing LLS;
- Nelnet;
- Great Lakes Educational Loan Services, Inc.; and
- Panhandle-Plains Student Loan Center.

## ***DEFAULT PREVENTION AND MANAGEMENT***

---

*FSA achieved a default recovery rate of approximately 9.5 percent in FY 2003, and it expects to increase that figure to at least 10 percent by FY 2005.*

*FSA's 5-Year Strategic Plan*

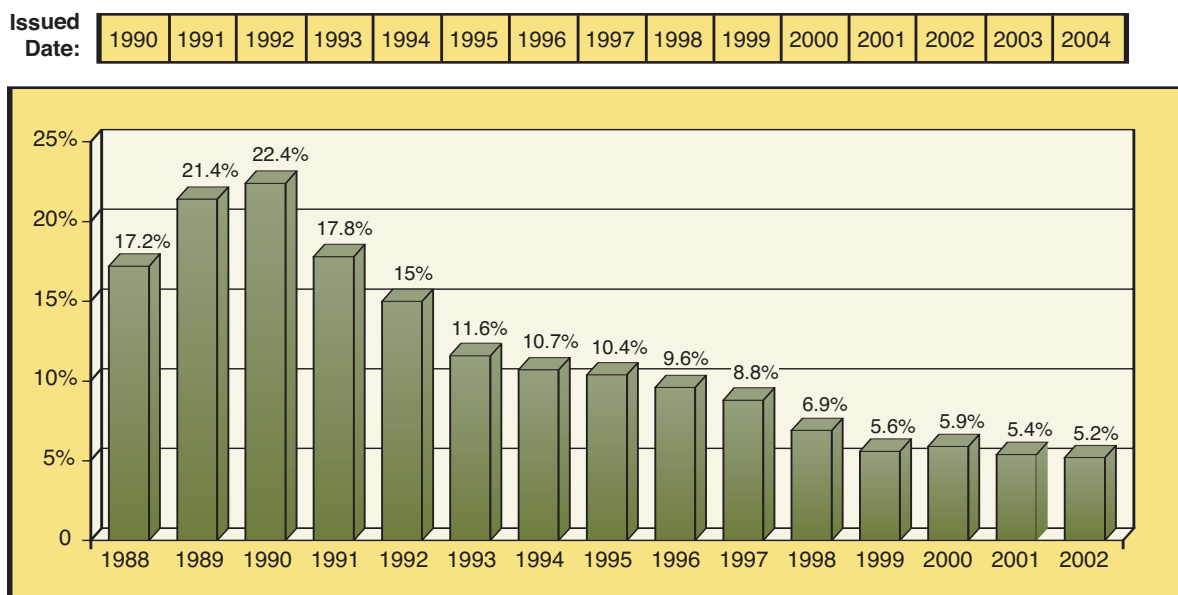
---

FSA has made excellent progress in reducing defaults in the student loan programs and in collecting from borrowers who have defaulted. FSA has worked with the community to increase its efforts in default aversion as well as maintaining and enhancing collection activities. In FY 2004, FSA announced the national FY 2002 cohort default rate fell to 5.2 percent, the lowest rate in history. FSA's Late-Stage Delinquency Assistance Project provides Direct Loan schools with informa-



tion about students nearing default and, as a result, schools are working with their students to ensure appropriate repayment options. Together with the FFEL community, FSA worked to make debt repayment a priority and FSA's efforts are paying off for both the students and the taxpayers.

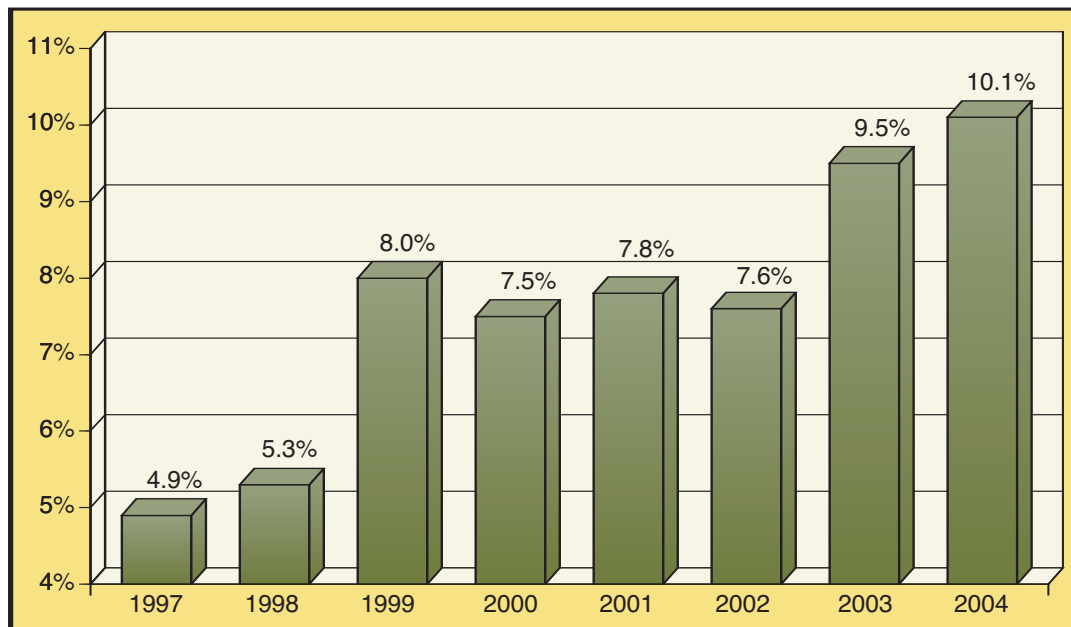
### National Student Loan Cohort Default Rates



In addition to the success in default aversion, FSA achieved significant progress in collections through both increased cure rates for delinquent Direct Loans and increased recovery rates for all defaulted loans. FSA achieved its FY 2004 goal to increase the cure rate on delinquent Direct Loans by 1 percent over the FY 2003 cure rate of 54.1 percent. In September 2004, FSA achieved a cure rate of 59.7 percent. Total non-consolidation default recoveries for FY 2004 reached \$1.6 billion, representing 10.1 percent of the FY 2004 FSA defaulted loan portfolio balance of \$15.9 billion. Total combined FSA and guarantor non-consolidation recoveries for the fiscal year totaled \$3.54 billion, an increase of 11.1 percent from FY 2003. The combined non-consolidation total represents 11.75 percent of the combined FY 2004 portfolio balance of \$30.22 billion.



### FSA Non-Consolidation Default Recovery Rate



### IDENTITY THEFT

Identity theft is one of the fastest growing crimes in the United States, affecting over 10 million people in 2003 and costing victims \$5 billion. College students tend to be particularly vulnerable due to, among other reasons, their relative inexperience in managing personal finances. In FY 2004, FSA, in collaboration with the OIG, established a campaign to warn students and parents about the increasing threat of identity theft. The Secretary launched the campaign with a press conference at Howard University, and the Department unveiled a new Web site to introduce some of the tools students should use to combat this growing problem. With the implementation of the new CSB solution, social security numbers will no longer be used as the borrower identifier of record. Additionally, FSA began including monthly identity theft avoidance tips on borrowers' Direct Loan billing statements reaching millions of borrowers each month. FSA's Student Aid Awareness and Outreach division added identity theft warnings to outreach publications and presentations. Identity theft prevention will be a key priority for FSA in FY 2005.





## OBJECTIVE 3: REDUCE PROGRAM ADMINISTRATION COSTS



---

*In recent years FSA has maintained a relatively flat operating budget while supporting continued increases in program volume and workload. FSA's ability to manage and control operating expenses is based on a philosophy of good fiscal management and continuous process improvement — practices that increase productivity and operational efficiencies — as well as innovation in FSA's products, services, and supporting technologies.*

---

*FSA's 5-Year Strategic Plan*

---

A critical component of FSA's business performance plan is the requirement to reduce the cost of administering the Title IV programs while continuing to increase service to students and program participants. In a static budget environment, FSA's workload continues to increase. Financial aid applications alone have increased by 35 percent since FY 1997. In FY 2004, FSA continued to decrease the unit administrative cost of delivering student aid programs through efficiency and productivity gains in its business processes. These gains allow FSA to successfully manage dramatically increasing workloads with little or no budgetary impact. FSA has developed an activity-based costing model to better manage costs and in FY 2005 will leverage the model to formulate budgets, forecast financial trends, and identify targets for business process improvements. With the recent re-compete of its private collection agency contracts, FSA will continue to reduce the Department's cost to collect on defaulted student loans while increasing overall collections.

### **PRODUCT IMPROVEMENT**

This year, FSA continued to work to improve various products and services. FSA evaluated the usability of its print, Web, and multimedia products by assessing user satisfaction, communication efficiency, and their ease of use. Targeted audiences included students, parents, high school counselors, and financial aid administrators. Staff monitored FSA's contact center interactions



and continued efforts to reduce call volumes by running FAQs and referrals to self-service on interactive voice response units, and regularly updated FAQs to improve effectiveness of contacts and information. As a result of customer feedback, FSA replaced the search engine for the Information for Financial Aid Professional (IFAP) site with Google.

FSA is reducing the administrative cost of delivering student aid programs by successfully automating many paper-based processes. *FAFSA on the Web* is FSA's electronic, web-based process that allows students to complete and submit their FAFSA. This online system transformed a complicated, time-consuming, paper-intensive financial aid application process into a cost-effective, customer-focused resource, increasing timeliness, accuracy, and efficiency for over 13 million students and their families annually. In FY 2004, approximately 80 percent of all applicants completed their FAFSA electronically. *FAFSA on the Web* has reduced the unit cost to process applications by approximately 75 percent and in FY 2004 reduced printing and postage costs by \$4 million.

### ***BUSINESS PROCESS REENGINEERING***

FSA reduced the cost to collect the default portion of the student loan portfolio serviced by private collection agencies (PCAs) from more than \$0.21 per dollar collected in FY 1998 to \$0.16 per dollar collected in FY 2004, while increasing overall collections six-fold during that same period. In October 2004, PCA contracts were re-competed to provide even greater savings. The new contract will use an adjusted fee structure to maximize competition among the agencies, reduce unit costs, and increase total collections through the life of the contracts. One of Borrower Services' regional service centers remains devoted exclusively to oversight of PCA activity and ensuring that the agencies maintain a high standard in meeting borrower needs. FSA provides a toll-free number for customer service allowing easy access for borrower complaints. In addition, FSA developed a new system to track customer concerns and complaints. This system is used to monitor complaint activity, trends and patterns to identify the need for intervention and possible corrective action by PCAs. It is also used to assess PCA's performance against customer satisfaction standards.



## **ACTIVITY-BASED COSTING**

---

*In FY 2004, FSA will reevaluate its baseline costs, focusing on data quality and reporting on business process metrics to better inform management and the public about FSA costs.*

*FSA's 5-Year Strategic Plan*

---

FSA's new Activity-Based Costing (ABC) model is an additional management tool to better measure the success of FSA's cost reduction strategies and more accurately manage FSA's unit cost structure. FSA's model drives allocations of dollars to specific activities, ultimately deriving a "unit cost" for those activities. FSA devoted FY 2004 to developing the ABC model and to running selected FY 2002 and FY 2003 data through the model to produce baseline unit costs. Unit costs each year going forward will be produced after the completion of the annual financial audit and production of audited financial statements.

FSA plans to use the ABC model to identify targets for business process improvement, provide annual and year-over-year comparative unit cost performance reporting, and better formulate annual budgets. The ABC model also enables FSA to better manage fixed and variable costs, to express the value of investments in unit cost savings, and to provide better contract negotiation and management.

## **ENTERPRISE PROCUREMENT PLAN (EPP)**

---

*Beginning in FY 2004 and continuing through FY 2008, FSA will implement its fully developed EPP to drive the procurement process and ensure efficient and effective business practices and operations.*

*FSA's 5-Year Strategic Plan*

---

In FY 2003 FSA developed the EPP, a strategy for planning, executing, and managing acquisitions. In addition to ensuring effective and efficient procurement processing, in FY 2004, the EPP's Quality Assurance program provided Independent Verification and Validation (IV&V) support for



four key system efforts. Traditional IV&V independence is achieved when the IV&V authority is vested in an organization separate from the development organization. FSA maintains an Interagency Service Agreement with GSA's Federal System Integration and Management Center to acquire the IV&V support of industry partners of which the majority are small businesses. Independence is ensured through four established mechanisms: technical independence, managerial independence, financial independence, and contractual independence. These independent reviews ensure that each step in the process yields the right result. It also ensures that all requirements are satisfied. IV&V reviews were performed on FSA's supporting infrastructure backbone, financial management system (FMS), and Electronic Records Management System, all previously implemented and now in maintenance mode. IV&V was also performed on initial phases of CSB.



## OBJECTIVE 4: IMPROVE HUMAN CAPITAL MANAGEMENT

---

*Human capital management is a critical component of FSA's current business operations and future initiatives. FSA is continuing to grow into an organization that empowers individuals to perform at a high level of effectiveness and efficiency. FSA is utilizing innovative hiring and employee development techniques aimed at attracting and retaining highly qualified individuals to create a more productive, results-oriented workforce. Additionally, the organization is committed to workforce development and training to ensure a skilled and highly qualified professional workforce.*

*FSA's 5-Year Strategic Plan*

---

With 47 percent of the FSA workforce eligible for retirement within the next five years, FSA faces significant human capital challenges. In FY 2004, FSA developed a comprehensive human capital management plan addressing FSA's critical workforce issues, including leadership development



and succession planning. In FY 2005, FSA will strengthen its results-oriented culture by further aligning individual performance plans to annual FSA performance goals, streamlining the FSA hiring process, and implementing enterprise succession planning.

## **WORKFORCE DEVELOPMENT**

---

*FSA's continued success in its current business operations and its future development initiatives depends heavily on a knowledgeable and well-trained workforce. FSA is committed to the development of outstanding leadership.*

---

### *FSA's 5-Year Strategic Plan*

---

As the federal government's first PBO, FSA is expected to operate as a results-driven organization with a focus on best-in-business management practices and outstanding customer service. In this capacity, FSA was granted by the Congress certain, limited managerial flexibilities over its human capital management, budget, and procurement activities. FSA is aggressive in utilizing those flexibilities.

In FY 2004, FSA, in collaboration with the nonpartisan, nonprofit Partnership for Public Service (PPS), developed a new comprehensive strategic human capital plan to map the organization's future and plot the succession of a rapidly retiring workforce. The plan has four objectives:

- integrate human capital into strategic planning and daily operations;
- identify, recruit, and develop results-oriented leaders;
- build capacity for high performance at all levels of the organization; and
- create a culture of continuous learning and innovation.

These objectives are aligned with the President's Management Agenda, the Department's Strategic Plan, and key principles outlined by the Office of Personnel Management and the GAO.

FSA's senior management developed a human capital calendar with annual budgeting and human capital activities. In addition, senior management developed a set of workforce performance





indicators identifying human capital metrics necessary to track the organization's progress.

Mission-critical positions were identified, and the current capacity for succession into these positions was analyzed. An FSA skills catalog was developed to document critical competencies by position.

The Career Zone offered several courses and workshops to FSA employees to improve their performance and help them to better manage their careers. Some of the courses offered include



technical workshops on simplified acquisition procedures, overview of Departmental contracting, data strategy, and National Student Loan Data System courses. Classes that assist employees in managing their careers include networking and interviewing workshops, federal resume writing, and skills assessment. In addition, the Career Zone provides one-on-one counseling ses-

sions, job search assistance and career management planning to FSA employees. To improve employee accountability, FSA is updating the system used to evaluate employee performance to more closely align individual awards to performance.

In FY 2004, eleven performance bonuses were awarded to the Chief Operating Officer (COO) and the executive managers in FSA. A performance bonus of \$60,000 was awarded to the COO. Ten performance bonuses were awarded to other executive managers in FSA. These awards ranged from \$6,000 (4 percent of annual salary) to \$33,250 (23 percent of annual salary), with a median award of \$17,500 (12 percent of annual salary).



## OBJECTIVE 5: IMPROVE PRODUCTS AND SERVICES TO PROVIDE BETTER CUSTOMER SERVICE

---

*FSA will make a continuous effort to improve its products and services to students and families and program participants such as schools, lenders, and agencies. Being aware of customer concerns is a critical component of FSA's efforts to improve federal student aid products and services. In FY 2003, FSA established new baseline measures for customer service levels, which will assist in this effort. FSA intends to reduce the complexity of its products and services, ensure that compliance is maintained, provide customers with 24/7 access, and promote increased self-service by customers.*

---

*FSA's 5-Year Strategic Plan*

---

As customers' needs evolve, FSA will constantly review its services, systems, and procedures to ensure they provide superior value and world-class service. In FY 2004, FSA received world-class



customer satisfaction scores for *FAFSA on the Web* and enhanced the award-winning *Student Aid on the Web*, its online comprehensive financial aid information Web site, where students and their families can receive information on preparing, applying, and paying for college. FSA also marked the five-year anniversary of the FSA

Ombudsman Office, a vital resource for student aid recipients resolving over 70,000 cases. FSA hosted over 5,000 financial aid administrators at three annual conferences, and outreach efforts continued to inform students and their families about applying for and paying for college. In FY 2005, FSA will continue to improve service to customers through process reengineering, innovation, and improvement efforts, specifically through its three major business initiatives: CSB, FEBI, and IPM.



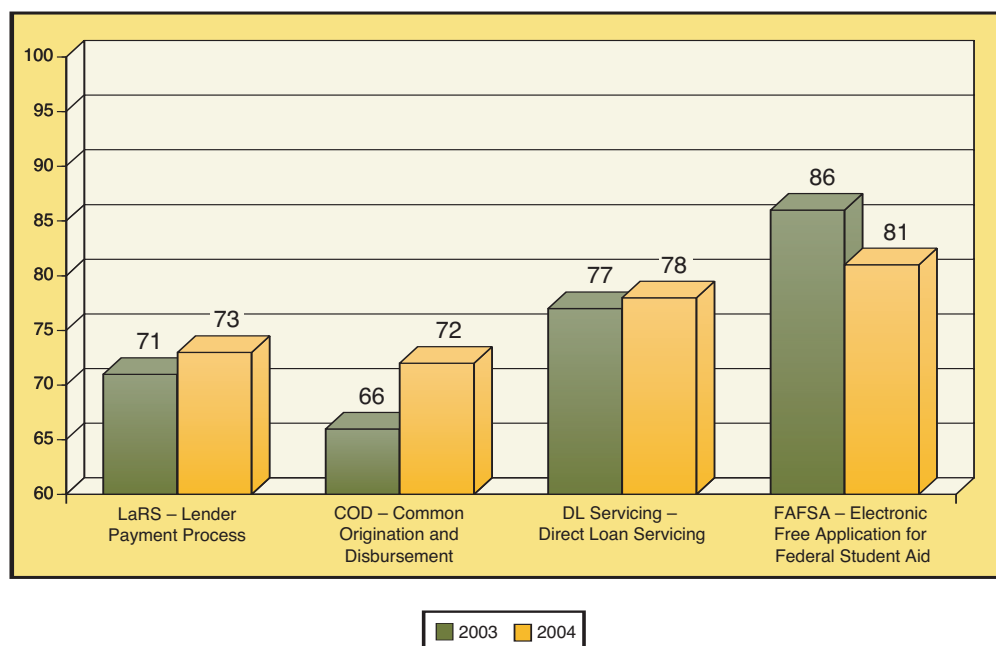
## ELECTRONIC PRODUCTS AND SERVICES

*FSA is committed to customer service and satisfaction. In FY 2004, FSA will identify and baseline the following customer satisfaction indicators of major operations: timeliness of product and service delivery; applicability of product functions and features to customer business needs; timeliness of response to customer requests and problems; and courtesy of FSA employees in their interactions with customers. These baseline measures will provide feedback to FSA's improvement process for products and services.*

*FSA's 5-Year Strategic Plan*

Using the national American Customer Satisfaction Index (ACSI), FSA conducted customer satisfaction surveys on its front-line products and systems including FAFSA on the Web, Direct Loan Servicing, the Lender Reporting System (LaRS) and COD. Direct Loan Servicing and LaRS scores

### FSA Customer Satisfaction

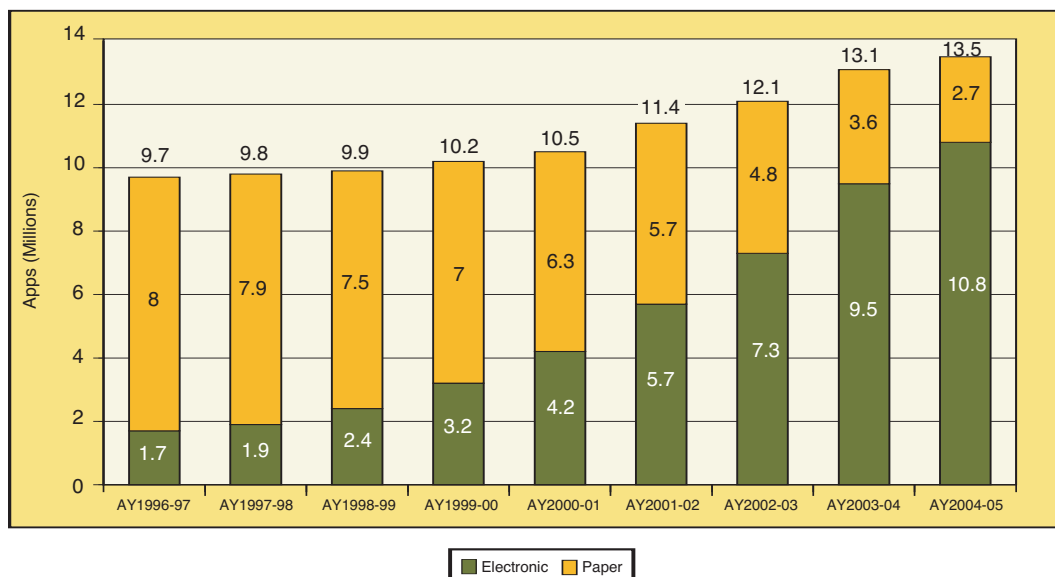


improved, exceeding the scores of Wachovia Bank and E-Trade, respectively. COD scores increased nearly 10 percent from 2003 scores as a result of focused customer satisfaction



improvement initiatives. Additionally, borrower participation in online Direct Loan services increased 26.9 percent as more borrowers transitioned to online services for making payments, viewing account balances and payment histories, changing billing options, and enrolling in electronic correspondence and billing. FAFSA on the Web remains a highly rated product, comparable to Google, Amazon.com, and Expedia. Additionally, FAFSA on the Web remains one of the highest rated E-government Web sites. FSA plans to further analyze the results of the survey and look for additional opportunities for improvement.

### FAFSA – Paper vs. Electronic



FSA continues innovating and improving its products and services for its customers. A significant achievement for FSA is the acceptance of *FAFSA on the Web* as the preferred method of completing the FAFSA. Almost 80 percent of all FAFSAs are now filed electronically — an incredible adoption rate for what was an entirely paper-bound process less than ten years ago. On its peak processing day, *FAFSA on the Web* received approximately 10 million hits hourly and processed over 600,000 unique visits. In recognition of its outstanding customer service value, *FAFSA on the Web* was a 2004 award finalist for a Government Solutions Center Pioneer Award.



In FY 2004, FSA launched *Student Aid on the Web* — an online tool to assist students and their parents as they plan for education beyond high school. Serving over 16 million unique visitors last year, *Student Aid on the Web* ([www.studentaid.ed.gov](http://www.studentaid.ed.gov)) provides students and parents with a wealth of resources on planning, applying and paying for college. An acknowledgement of *Student Aid on the Web*'s rapid acceptance, the Federal Leadership Council's 2004 Showcase of Excellence Award was presented to Student Aid on the Web, recognizing it as the finest citizen-centric electronic government IT project.

In addition to *FAFSA on the Web* and *Student Aid on the Web*, FSA continued to improve many of its other products and services. The usability and design of print, Web, and multimedia products were evaluated by assessing user satisfaction, and the requested changes were implemented. Call center interactions were monitored, and efforts were continued to reduce call volumes by incorporating frequently asked questions into self-service interactive voice response units. In response to customer feedback, FSA is replacing outdated search engine technology, throughout all FSA sites, with Google to improve usability.

## **AID AWARENESS AND ACCESS**

---

*In FY 2003, FSA developed a comprehensive aid awareness and access strategy. This strategy establishes partnerships with organizations at the national, regional and local levels that have the common goal of promoting awareness of and access to aid for postsecondary education. The partnerships communicate the importance of aid for postsecondary education in their public messages. This effort will be followed in FY 2004 by the development of a conference outreach strategy for coordinating FSA participation and ensuring the distribution of current and accurate information about federal student aid programs and processes. FSA will then identify partnering opportunities at the national, regional and local levels that permit the pooling of resources and the improvement of productivity.*

*FSA's 5-Year Strategic Plan*

---



In FY 2004, FSA continued its efforts to inform students and their families about postsecondary education planning and decision-making. In addition to its Web sites for parents, students, and counselors, FSA disseminated college access and financing information in a variety of languages (e.g., English and Spanish) and formats (e.g., print publications, Braille, e-mail, and hard copy correspondence). FSA conducted several types of conferences showcasing the student aid process. In addition to officially launching *Student Aid on the Web*, FSA participated in a Department PBS television program on planning and paying for college. By leveraging partnership activities with student/youth-centered organizations, FSA directly disseminated information to thousands of students and families at college fairs and financial aid night presentations.

### ***FSA CONFERENCES***

FSA conferences provide financial aid professionals with the opportunity to learn more about FSA programs, its systems, resources, and revisions to the laws and regulations affecting Title IV programs. In FY 2004, FSA hosted over 5,000 postsecondary financial aid administrators at its two Electronic Access Conferences (EAC) and its Annual Spring Conference. FSA also hosted two satellite videoconferences for approximately 8,000 high school counselors and higher education financial aid administrators to update them on the Title IV aid application process.

### ***FSA OMBUDSMAN***



In FY 2004, FSA marked the five-year anniversary of the FSA Ombudsman. Established by the 1998 Amendments to the Higher Education Act, the office works with student loan recipients, loan holders, GAs, and schools to provide informal dispute resolution services. The Ombudsman's office analyzes complaint data to identify broader systemic issues impacting Title IV programs. Information about the





FSA Ombudsman is disseminated throughout the loan repayment process, particularly in exit counseling and specified due diligence activities. The Ombudsman also maintains a Web site ([www.ombudsman.ed.gov](http://www.ombudsman.ed.gov)) and produces collateral materials to provide the higher education community with additional sources of information on their services.

Since inception, the FSA Ombudsman Office has resolved more than 70,000 complaints. Of the 14,688 complaints filed in FY 2004, 10,991 were resolved within one to three days of the initial complaint. Nearly 80 percent of the 3,697 research cases were resolved before the close of the fiscal year. The average research case borrower has 6.5 loans with 32 percent of the loans in repayment for less than five years and 23 percent in default. Because of the need for extensive research and client interaction, resolution generally requires 45–90 days.

Effectiveness of the office is measured through customer feedback and weekly surveys. Cases are chosen at random, and borrowers are asked to rate service accessibility, representatives' knowledge, timeliness of resolution, level of satisfaction with resolution, and overall Ombudsman service. Each item is measured on its own scale and is part of a weighted average for overall satisfaction. On a scale of 1–5, where 1 is the highest possible rating, results are calculated weekly and cumulatively. FSA Ombudsman considers only ratings of 1.9 and below as meeting its performance goals. The final overall satisfaction rating for the FY 2004 cases requiring extensive research was 1.69. For the one-issue general assistance complaints, the final rating was 1.78. Weekly and cumulative results were within the goal throughout FY 2004.



## **OBJECTIVE 6: DELIVER STUDENT AID EFFECTIVELY AND ACCURATELY**

---

*In FY 2004, FSA added a sixth strategic objective to recognize the organization's day-to-day operations and the need to execute these responsibilities flawlessly.*

*FSA's 5-Year Strategic Plan*

---

In FY 2004, FSA continued its comprehensive oversight activities to ensure the effective and accurate delivery of student aid. FSA enhanced its internal systems to improve the monitoring of its operations and proposed legislative and regulatory recommendations to the Office of Postsecondary Education. In FY 2005, FSA forecasts that it will deliver \$73 billion in student aid to 10 million students and their families, and that 14 million students will complete the FAFSA, approximately 82 percent electronically.

### **PERFORMANCE MANAGEMENT**



Given the size and scope of FSA's operations, comprehensive performance management is critical to ensuring that aid is delivered effectively and accurately. In FY 2004, FSA continued to improve the systems and procedures used to identify, budget, select, monitor, and improve organizational operations. Performance monitoring activities included annual performance planning, periodic performance reporting, strategic systems integration oversight (Business and Technology Integration Group), customer feedback (Customer Service Review Board), and senior management review and approval processes (Investment Planning Committee). In FY 2004, FSA improved its strategic planning and reporting to better align its Annual Performance Reports and Plans

with its 5-Year Strategic Plan. FSA integrated its ABC model to provide better unit cost control and management capabilities. In FY 2004, FSA enhanced its Investment Planning Process (IPP)



to include project status reporting as part of its regular review schedule. For each project, the status of scope, schedule, cost, quality, and overall status, as well as major accomplishments, upcoming milestones, and known issues are reported quarterly. In addition, FSA developed human capital performance metrics and aligned senior management performance plans with organizational objectives. As a result of its commitment to implementing financial management controls, FSA once again received a clean audit opinion and reported no material weaknesses.



### ***FY 2004 OPERATIONAL HIGHLIGHTS***

- \$13.0 billion disbursed in Federal Pell Grants to 5.3 million recipients;
- \$13.2 billion disbursed in new Direct Loans to 1.9 million borrowers;
- \$39.0 billion dollars of new Federal Family Education Loans delivered to 5.4 million borrowers;
- \$3.4 billion in Campus-Based awards disbursed to nearly 3.0 million students;
- \$6.3 billion in Direct Consolidation Loans disbursed to 269,214 borrowers;
- \$200 million in LEAP/SLEAP funds disbursed to state grant agencies;
- \$89 billion Direct Loan portfolio serviced;
- 28 million payments processed totaling over \$13.6 billion in Direct Loan payments from borrowers;
- \$17.4 billion defaulted loan portfolio managed representing over two million active borrower accounts and resulting in \$1.585 billion dollars collected;
- 635 program reviews performed including 598 reviews of lenders, 19 reviews of GAs and 18 reviews of servicers; and
- 2,760 schools (44.7 percent) received comprehensive reviews (including on-site, off-site and records reviews).



## ***LEGISLATIVE AND REGULATORY IMPROVEMENTS***

The PBO legislation included in the Higher Education Act (HEA) contains a provision that requires FSA's COO to make legislative and regulatory recommendations to the Secretary. In anticipation of the upcoming reauthorization of the HEA, FSA staff prepared a set of legislative recommendations for consideration by FSA's senior management for submission to the Assistant Secretary for Postsecondary Education for inclusion with other recommended changes from the Office of Postsecondary Education. At the Administration's discretion, all or some of these recommendations may be included in any reauthorization proposal that may be forwarded for submission to Congress. In accordance with the provisions of the HEA, FSA's reauthorization recommendations will focus on ways to improve service and ensure the integrity of the federal student assistance programs. However, they also include other recommendations based upon FSA's ongoing processes, interactions and oversight. Additionally, in preparation for potential legislative actions, FSA developed a preliminary operations plan for implementing a data match with the Internal Revenue Service.

## ***CONCLUSION***

In FY 2004, FSA helped disburse more than \$69 billion in aid to more than 10 million students and families attending over 6,200 schools. We effectively and efficiently ran operations and met goals and objectives as a PBO, including improving customer service, enhancing program integrity, and pursuing systems integration and cost reduction initiatives. *We Helped Put America Through School* by providing the right aid to the right students at the right time, ensuring access to postsecondary education, while reducing incidence of waste, fraud, and abuse in the student aid programs.



# APPENDIX A

## FY 2004 FINANCIAL STATEMENT

- *LETTER FROM FSA CFO*
- *FINANCIAL DISCUSSION AND ANALYSIS*
- *PRINCIPAL FINANCIAL STATEMENTS*










## UNITED STATES DEPARTMENT OF EDUCATION

*Federal Student Aid  
Chief Financial Officer*

### MEMORANDUM

TO: Thomas A. Carter  
Deputy Inspector General

FROM: Victoria L. Bateman   
Chief Financial Officer  
Federal Student Aid

SUBJECT: DRAFT AUDIT REPORTS  
Fiscal Years 2004 and 2003 Financial Statement Audit  
U.S. Department of Education ED-OIG/A17E0007

Federal Student Aid (FSA) wishes to express our appreciation for the efforts and professionalism of the Office of the Inspector General and our auditors, Ernst and Young (EY), in their audit of our Fiscal Year (FY) 2004 financial statements. We concur with the findings and recommendations. FSA is committed to maintaining an unqualified opinion in future fiscal years and continues to prioritize several action items to eliminate reportable conditions and other matters as noted in this report.

FSA will continue to support the Department's efforts to address the reportable condition related to credit reform. We recognize that significant additional work remains to be accomplished in order for the Department to have a fully institutionalized practice.

FSA continues to address the reportable condition related to IT security. In response to the Federal Information Security Management Act audit report, all corrective action items with respect to the Virtual Data Center were completed in FY2004. FSA and the Department continue to implement additional improvements.

Once again, we thank the Office of the Inspector General and EY for their efforts to complete a successful audit of FSA's financial statements and internal controls.

# **FINANCIAL DISCUSSION AND ANALYSIS**

## **Overview**

FSA is committed to providing sound management, financial systems, and controls to ensure that students receive education funds according to applicable laws and regulations. FSA prepares annual financial statements in conformance with accounting principles generally accepted in the United States. Its financial statements are subject to an annual independent audit to ensure that they are reliable and fairly present FSA's financial position.

In FY 2004, FSA achieved its third consecutive unqualified audit opinion on its financial statements. This sustained achievement is critical to FSA's removal from GAO's High – Risk List and is the result of substantial improvements to internal controls, continued improvement in its accounting and financial processes, and FSA's strategic planning and financial reporting.

In FY 2003, FSA's independent auditors recommended that the organization address reportable conditions related to credit reform and controls surrounding Information Technology security (modified repeat reportable conditions). A corrective action plan was developed to monitor progress on implementing the recommendations. Beginning in December 2003, FSA and the Department undertook a comprehensive review of the current credit reform model, key assumptions, and outputs to improve management controls and analysis. Progress was made in FY 2004 in addressing findings in these areas. FSA and the Department continue to implement additional improvements.

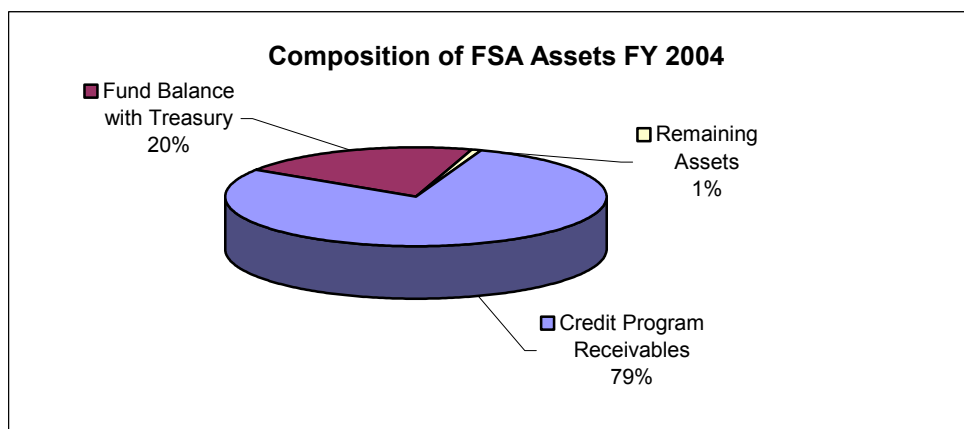
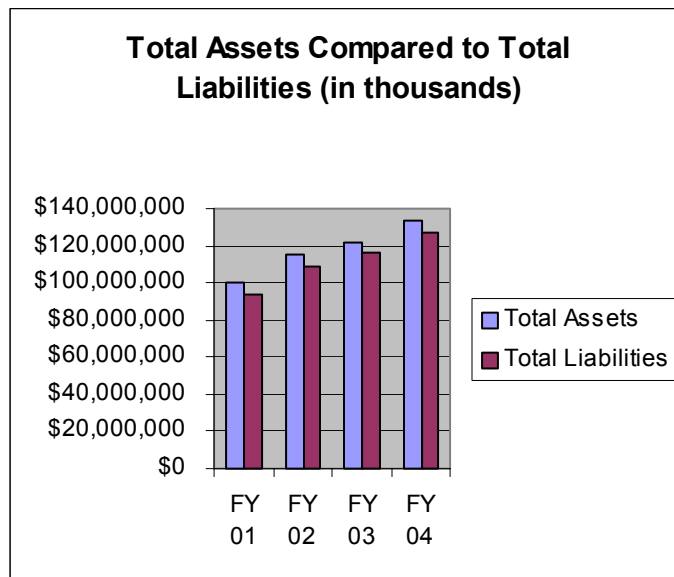
## **Financial Position**

FSA received an unqualified opinion on its FY 2004 financial statements from the independent accounting firm of Ernst & Young, LLP. For FY 2003 and FY 2004, FSA prepared its Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Statement of Financing on a consolidated basis and its Statement of Budgetary Resources on a combined basis as required by OMB Bulletin 01-09, Form and Content of Agency Financial Statements. The Report of Independent Auditors (opinion) on these statements and accompanying Reports on Internal Control and Compliance with Laws and Regulations are included in this report.

For the FFEL and DL programs, appropriations are available to cover the subsidy cost of each program as well as administrative expenses. Subsidy expenses are the estimated costs of funding the direct loans and loan guarantees that help students have access to higher education. The Pell Grant Program receives one appropriation that covers actual grant disbursements. Appropriation authority is available as needed on a permanent basis to finance operations resulting from loans guaranteed in the years before FY 1992.

**The Balance Sheet.** The Balance Sheet has total assets of \$133 billion. The increase in total assets, which is an increase of \$12 billion over FY 2003, is attributable to an increase in the Fund Balance with Treasury compared to the prior year and the growth of loan receivables.

FSA has total liabilities for FY 2004 of \$127 billion. Most of FSA liabilities consist of Treasury debt, which is the result of the Department's focus on ensuring that funds are available for any student desiring a postsecondary education. The Treasury debt of \$96.4 billion is for the DL Program.



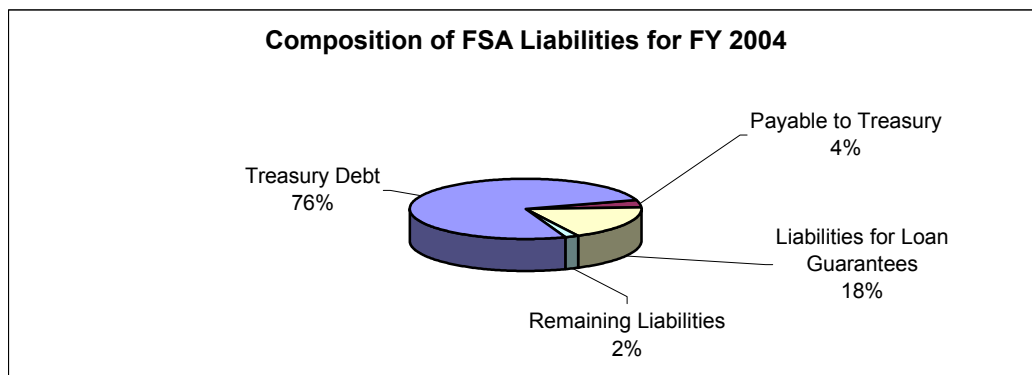
Credit Program Receivables and Fund Balance with Treasury have steadily increased. Credit program receivables are loans and accrued interest owed to the government from students who have either borrowed funds under the DL program or defaulted on their

loans under the FFEL program. As of September 30, 2004, there are \$93.7 billion of DL credit program receivables and \$10.7 billion of Credit Program Receivables under the FFEL program, which are defaulted loan guarantees.

Fund Balance with Treasury represents the cash account balance with Treasury. These accounts receive warrants that provide cash for operations and receive collections from students. Operating expenditures are also recorded against Fund Balance with Treasury.

FY 2004 increases in Fund Balance with Treasury were caused primarily by the FFEL FY 2004 subsidy appropriation to cover future defaults, and collections from borrowers and fees from participating lending institutions. In addition, for DL there were net increases in Treasury Debt and collections on principal, interest and fees from borrowers.

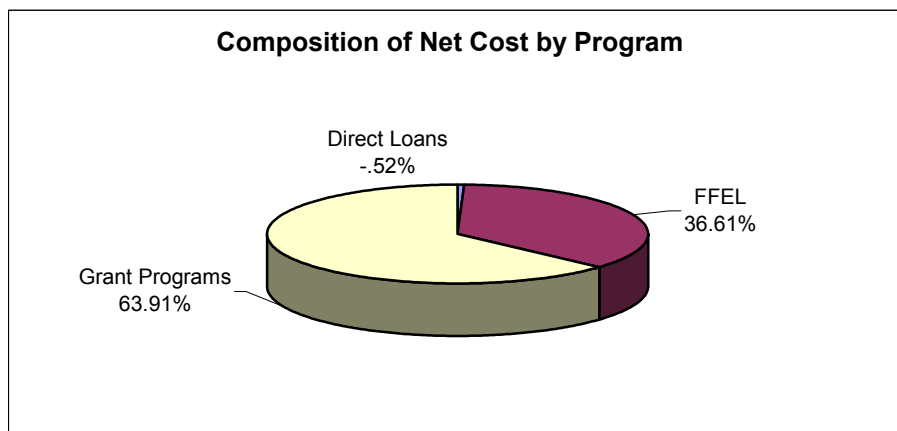
The remaining assets include accounts receivable, cash and other monetary assets, and general property, plant, and equipment.



Treasury debt and liabilities for loan guarantees have increased steadily. Treasury debt is the amount borrowed from and owed to Treasury to fund direct loans to students. The liabilities for loan guarantees under FFEL are the estimated costs on a present value basis of the net long-term cash outflows as a result of defaults and interest supplements which are offset by fees. Loan guarantees help students receive loans from the private sector. The Payable to Treasury balance is the sum of the amount owed for downward subsidy re-estimates and for amounts owed to Treasury by the liquidating fund. The remaining liabilities include Accounts Payable, Federal Employee and Veterans' Benefits, and the Accrued Grant Liability.

FSA's Net Position as of September 30, 2004 is \$6.1 billion, which increased by \$0.9 billion compared to \$5.2 billion for September 30, 2003 due to a decrease in unfunded subsidy accruals in the DL program, net of an increase in unfunded subsidy accruals in the Guaranteed loan program, and a decrease in undisbursed Pell Grants as of year-end.

**Statement of Net Cost.** FSA had total net costs of \$23.7 billion during FY 2004. In the FFEL program, the total net cost is \$8.6 billion. In the DL Program, earned revenues exceeded total costs by \$124 million. The grant program had a total net cost of \$15.1 billion. The net cost with the public is composed of subsidy expenses and the cost of grants. Subsidy expenses are the estimated costs of funding the direct loans and loan guarantees. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows. Indirect costs are Departmental administrative costs including supplies, training costs, rent/lease agreements, mail services, and other costs allocated to each FSA program as part of its effort to report full cost.



**Statement of Budgetary Resources.** The Statement of Budgetary Resources compares the budgetary resources provided with the status or execution of those resources and shows the amount of net outlays. This statement shows that FSA had \$84.2 billion in combined budgetary resources of which \$15.7 billion remained unobligated and not available at year-end. FSA had total net outlays for FY 2004 of \$21.6 billion.

**Statement of Financing.** The Statement of Financing demonstrates the relationship between an entity's proprietary and budgetary accounting information by linking the net cost of operations (proprietary) with net obligations (budgetary) through the identification of key differences between the two statements. The statement identifies \$20.6 billion of resources used to finance FSA activities.

## **MANAGEMENT CONTROLS AND LEGAL COMPLIANCE**

FSA is committed to management excellence in administering Title IV programs and to maintaining accountability for its annual performance. FSA is required to provide assurance that its financial systems and management controls adhere to applicable guidance and standards. During FY 2003, FSA aligned its objectives and goals with those of the Department. As a result, FSA improved its operations and informed the Department there were no material weaknesses to report in FY 2003. In FY 2004, FSA once again reported no material weaknesses.

In addition to FSA's internal review processes, other reviews evaluate the adequacy and efficiency of the operations and systems of FSA and its partners. These include external audits by the GAO and independent accounting firms, internal audits by the Office of Inspector General (OIG) and reviews by FSA program offices. The audits and reviews also help ensure that management controls as well as financial management systems comply with the standards established by the Federal Managers' Financial Integrity Act (FMFIA), Federal Financial Management and Improvement Act (FFMIA), Paperwork Reduction Act, Computer Security Act and Office of Management and Budget (OMB) Circulars A-123, A-127, A-130 and A-133.

FSA program managers have oversight responsibility for assuring that corrective actions are developed and implemented in response to audit findings and recommendations contained in audit reports. Progress on the plans is monitored throughout the year and program managers are held accountable for implementing the corrective actions within the required time frame.

The following portion of the MD&A describes the actions FSA is taking to improve financial integrity and accountability. FSA is also providing updates on compliance with legal requirements.

### **INITIATIVES to IMPROVE FINANCIAL INTEGRITY and ACCOUNTABILITY**

#### **Improved Management Controls**

Effective management controls are essential to programmatic and financial integrity and accountability in order to prevent waste, fraud and abuse. Program managers assess the FSA management control environment throughout the year for adequacy of management control systems. Below are the highlights of financial management improvements implemented by FSA during FY 2004.

- Collaborated with the Department to get to "Green" status for the category of Improved Financial Performance on the President's Management Agenda;



- Reduced reconciliation time for all FSA operating partner activity to FMS (FSA ledger) and to FMSS (Department's general ledger) to within 8-15 days after month-end close;
- Established a working group with representatives from Budget Services, and other principal offices within the Department to discuss credit reform improvement activities;
- Continued to strengthen the financial reporting activities to ensure full compliance with OMB Circular A-123, Management Accountability and Control, and Credit Reform;
- Prepared and reviewed quarterly and annual financial statements to meet OMB's reporting requirements;
- Worked with program managers to make significant progress in development of Common Services for Borrowers (CSB), which will modernize and combine Direct Loan Servicing System (DLSS), Loan Consolidation (LC), Debt Management Collection System (DMCS) and Conditional Disability Discharge Tracking System (CDDTS) into a single integrated system. The CSB solution will:
  - Optimize portfolio management
  - Integrate systems and data
  - Realize operational efficiencies to reduce cost
  - Improve tools for servicing student aid obligations
  - Create adaptability and flexibility in systems
  - Improve customer service
- Established weekly DL issues meetings with DL program managers to improve the tracking and monitoring of outstanding issues.
- Worked with D L program managers to implement intra-system and inter-system balancing reports between Common Origination Disbursement (COD) system and FMS (FSA ledger) to ensure the integrity of data.

## **Reconciliations**

High priority was given in FY 2004 to sustaining the unqualified opinion on the financial statements. Performing reconciliations and analyses of the underlying data supporting account balances is crucial to reaching that goal. Although FSA consistently reconciled Operating Partner activity and balances to its FMS and the Department's general ledger within 30 days after month-end close throughout FY 2003, its goal in FY 2004 was to further reduce that time frame. Currently, major reconciliations are being completed within 8 to 15 days after month-end close.

## **Financial Management System (FMS)**

The FSA FMS allows the FSA CFO to account for all FSA program transactions (e.g., FFEL, Pell, DL, etc.), make payments, perform funds control, and create financial reports. FMS is the single point of financial information for FSA, integrating data from several sources. Accordingly, FMS provides consolidated data to support key management analysis and is the single source within the Department for comprehensive FSA-wide school information.

During FY 2004, a number of new controls were implemented in FMS producing positive results. First, FSA CFO implemented a new set of change management processes for FMS that include the use of IBM Rational change management tools. These new processes greatly strengthen FSA procedures for code management and capturing and maintaining configuration management documentation. The new processes address a previous management letter comment.

Second, FSA CFO implemented a new automated budget funding entry initiative to reduce the number and dollar amount of manual entries in FMS. In FY 2003, manual entries accounted for approximately 32% of the dollar volume for transactions in FMS. This enhancement is expected to greatly reduce that dollar volume by eliminating the need for manual entry of budget funding transactions in FMS. These transactions will be automatically interfaced with the Department's general ledger system.

Third, FSA CFO established new system alerts, identifying unprocessed transactions among COD, FMS and Grants Administration and Payment System (GAPS). These e-mail alerts notify system and program operations staff of unprocessed transactions so that immediate action can be taken.

Fourth, the Form 2000 system was enhanced. The Form 2000 system is used by GAs to request and make payments to and from the Department. The information entered into Form 2000 is also used by FSA and ED to monitor the following GA activity: 1) Federal Fund, Operating Fund, and Restricted Account balances, 2) federal receivable balances and 3) delinquencies by debt. The Form 2000 enhancements included improved reporting and audit trails to strengthen internal controls and expanded use of FSA interface standards for obtaining data from the GAs and from the National Student Loan Data System (NSLDS).

In addition to new system controls, FSA CFO has continued to improve processes, making them more efficient and effective. For example, for FY 2003, FSA CFO developed a year-end closing schedule that helped FSA to complete year-end close in six business days at the beginning of October. This schedule was further refined to implement a three-business day year-end close for FY 2004.

Finally, even as incremental process improvements and strengthened controls are implemented in FMS processes, the Department is working to upgrade its core financial management system into one Department-wide solution. This implementation effort is

referred to as the Oracle 11i environment, or O11ie. As part of O11ie, the Department expects to recognize cost savings from consolidating two instances of the Oracle Federal Financials application into one, while realizing more effective reconciliation and other controls for the Department.

## **Improper Payments Reporting**

For the past several years, FSA has performed an analysis to determine its estimate of erroneous payments to demonstrate that its program funds were materially spent in accordance with laws and regulations. This analysis was expanded to satisfy the Improper Payments Information Act of 2002 (P. L. 107-300). The Act provides guidance on identifying and reducing erroneous payments.

FSA's improper payments rate is estimated to be less than 1.0 %. The majority of this amount is estimates of over and under payments, based on the possible over and under reporting of applicant income. To address this issue, the Department, OMB, and the Treasury Department developed and submitted to Congress proposed legislation to authorize the matching of federal student aid applicant data to tax return data. Passage of this legislation will further reduce the minimal rate of improper payments in these programs.

## **Legal Compliance**

### **The Federal Managers' Financial Integrity Act (FMFIA), Sections 2 and 4, Management Control and Financial Management Systems**

The FMFIA requires the Secretary to report annually to the President and Congress regarding the adequacy of the Department's management control and financial management systems. In FY 2003, through the implementation of corrective action plans developed by program managers, the Department determined that previously identified material weaknesses were no longer considered material. FSA did not identify any new material weaknesses under FMFIA during FY 2004.

#### **Limitations of the Financial Statements**

The financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with accounting principles generally accepted in the United States for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

**United States Department of Education**  
**Federal Student Aid**  
**Consolidated Balance Sheet**  
**As of September 30, 2004 and 2003**  
(Dollars in Millions)

	Fiscal Year 2004	Fiscal Year 2003
<b>Assets:</b>		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	\$27,343	\$22,736
Accounts Receivable (Note 5)		
Total Intragovernmental	27,343	22,736
Cash and Other Monetary Assets (Note 3)	1,040	1,107
Accounts Receivable, Net (Note 5)	141	154
Credit Program Receivables, Net (Note 4)	104,612	97,615
General Property, Plant and Equipment, Net	13	17
Other Assets	39	39
Total Assets	\$133,188	\$121,668
<b>Liabilities:</b>		
Intragovernmental:		
Accounts Payable	\$3	\$4
Treasury Debt (Note 6)	96,421	91,787
Guaranty Agency Federal and Restricted Funds Due to Treasury (Note 3)	1,040	1,107
Payable to Treasury (Note 7)	4,993	7,023
Other Intragovernmental Liabilities (Note 8)	1	1
Total Intragovernmental	102,458	99,922
Accounts Payable	368	199
Accrued Grant Liability (Note 10)	637	551
Liabilities for Loan Guarantees (Note 4)	23,329	15,432
Federal Employee and Veterans' Benefits (Note 9)	4	5
Other Liabilities (Note 8)	273	320
Total Liabilities (Note 9)	\$127,069	\$116,429
Commitments and Contingencies (Note 15)		
<b>Net Position:</b>		
Unexpended Appropriations (Note 11)	\$9,181	\$9,814
Cumulative Results of Operations (Note 11)	(3,062)	(4,575)
Total Net Position	\$6,119	\$5,239
Total Liabilities and Net Position	\$133,188	\$121,668

The accompanying notes are an integral part of these statements.

**United States Department of Education**  
**Federal Student Aid**  
**Consolidated Statement of Net Cost**  
**For the Years Ended September 30, 2004 and 2003**  
(Dollars in Millions)

	Fiscal Year 2004	Fiscal Year 2003
<b><i>Program Costs</i></b>		
<b>Program A (Enhancement of Postsecondary and Adult Education)</b>		
Intragovernmental Gross Costs	\$6,307	\$6,569
Less: Intragovernmental Earned Revenue	1,626	1,534
<i>Intragovernmental Net Costs</i>	4,681	5,035
 Gross Costs with the Public	 23,746	 21,950
Less: Earned Revenues from the Public	4,761	4,954
<i>Net Costs with the Public</i>	18,985	16,996
 <b>Program A Total Net Cost</b>	 \$23,666	 \$22,031
 <b>Net Cost of Operations</b>	 <b>\$23,666</b>	 <b>\$22,031</b>

The accompanying notes are an integral part of these statements.

**United States Department of Education**  
**Federal Student Aid**  
**Consolidated Statement of Changes in Net Position**  
**For the Years Ended September 30, 2004 and 2003**  
(Dollars in Millions)

	Fiscal Year 2004		Fiscal Year 2003	
	Cumulative Results	Unexpended Appropriations	Cumulative Results	Unexpended Appropriations
Beginning Balance	\$(4,575)	\$9,814	\$(3,911)	\$10,226
Beginning Balance, As Adjusted	\$(4,575)	\$9,814	\$(3,911)	\$10,226
Budgetary Financing Sources				
Appropriations Received		\$27,729		\$25,353
Appropriations Transferred - In/Out (+/-)				(15)
Other Adjustments (+/-)		(579)		(572)
Appropriations Used	\$27,783	(27,783)	\$25,178	(25,178)
Other Financing Sources				
Imputed Financing	10		30	
Adjustments to Financing Sources (+/-)	(2,614)		(3,841)	
Total Financing Sources	\$25,179	\$(633)	\$21,367	\$(412)
Net Cost of Operations (+/-)	\$(23,666)		\$(22,031)	
Ending Balances (Note 11)	\$(3,062)	\$9,181	\$(4,575)	\$9,814

The accompanying notes are an integral part of these statements.



**United States Department of Education**  
**Federal Student Aid**  
**Combined Statement of Budgetary Resources**  
**For the Years Ended September 30, 2004 and 2003**  
(Dollars in Millions)

	Fiscal Year 2004		Fiscal Year 2003	
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts
<b>Budgetary Resources:</b>				
Budget Authority :				
Appropriations Received	\$27,729		\$25,353	
Borrowing Authority		\$22,383		\$21,726
Contract Authority				
Net Transfers			(15)	
Other				
Unobligated Balance:				
Beginning of Period	2,320	9,765	3,525	7,804
Spending Authority From Offsetting Collections:				
Earned				
Collected	5,085	37,679	5,303	32,955
Receivable From Federal Sources		4		
Change in Unfilled Customer Orders				
Without advance from Federal sources	(1)		1	
Subtotal	\$5,084	\$37,683	\$5,304	\$32,955
Recoveries of Prior Year Obligations	1,151	3,047	864	269
Permanently Not Available	(6,135)	(18,825)	(5,705)	(17,401)
<b>Total Budgetary Resources (Note 13)</b>	<b>\$30,149</b>	<b>\$54,053</b>	<b>\$29,326</b>	<b>\$45,353</b>
<b>Status of Budgetary Resources:</b>				
Obligations Incurred: (Note 13)				
Direct	\$28,582	\$38,925	\$27,006	\$35,588
Reimbursable			1	
Subtotal	\$28,582	\$38,925	\$27,007	\$35,588
Unobligated Balance:				
Apportioned	62	948	48	396
Unobligated Balance Not Available	1,505	14,180	2,271	9,369
<b>Total Status of Budgetary Resources</b>	<b>\$30,149</b>	<b>\$54,053</b>	<b>\$29,326</b>	<b>\$45,353</b>
<b>Relationship of Obligations to Outlays:</b>				
Obligated Balance, Net, Beginning of Period	\$10,332	\$8,390	\$9,919	\$6,786
Obligated Balance, Net, End of Period:				
Accounts Receivable		(2)		
Unfilled customer orders from Federal Sources			(1)	
Undelivered Orders	8,949	7,656	9,546	8,373
Accounts Payable	851	124	787	16
Outlays:				
Disbursements	27,963	36,488	25,728	33,716
Collections	(5,086)	(37,679)	(5,304)	(32,955)
Subtotal	\$22,877	(\$1,191)	\$20,424	\$761
Less: Offsetting Receipts	51		44	
<b>Net Outlays (Note 13)</b>	<b>\$22,826</b>	<b>(\$1,191)</b>	<b>\$20,380</b>	<b>\$761</b>

The accompanying notes are an integral part of these statements.

**United States Department of Education**  
**Federal Student Aid**  
**Consolidated Statement of Financing**  
**For the Years Ended September 30, 2004 and 2003**  
**(Dollars in Millions)**

	Fiscal Year 2004	Fiscal Year 2003
Resources Used to Finance Activities		
Budgetary Resources Obligated		
Obligations Incurred (Note 14)	\$(67,507)	\$(62,595)
Less: Spending Authority from Offsetting Collections & Recoveries	46,965	39,392
Obligations Net of Offsetting Collections and Recoveries	(20,542)	(23,203)
Less: Offsetting Receipts	(51)	(44)
Net Obligations	\$(20,593)	\$(23,247)
Other Resources		
Imputed Financing From Costs Absorbed by Others	(10)	(30)
Net Other Resources Used to Finance Activities	(10)	(30)
Total Resources Used to Finance Activities	\$(20,603)	\$(23,277)
Resources Used to Finance Items Not Part of Net Cost of Operations		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not Yet Provided (+/-)	\$1,541	\$(1,975)
Resources that Fund Expenses Recognized in Prior Period (Note 15)	255	\$(1,216)
Credit Program Collections Which Increase/Decrease Liabilities for Loan Guarantees or Credit Program Receivables, Net including Allowances for Subsidy	35,282	31,745
Other		
Resources Used to Finance the Acquisition of Fixed Assets, or Increase/Decrease Liabilities for Loan Guarantees or Credit Program Receivables, Net in the Current or Prior Period	(31,081)	(28,048)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	\$5,997	\$506
Total Resources Used to Finance the Net Cost of Operations	\$(26,600)	\$(23,783)
Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Periods		
Increase in Annual Leave Liability	\$(7)	\$(3)
Upward/Downward Reestimates of Credit Subsidy Expense	(1,559)	\$(1,318)
Increase in Exchange Revenue Receivable from the Public	1,070	\$1,088
Other (+/-) (Note 15)	58	43
Total Components of the Net Cost of Operations that Will Require or Generate Resources in Future Periods	\$(438)	\$(190)
Components Not Requiring or Generating Resources		
Depreciation and Amortization	\$1,805	\$1,942
Other (+/-)	1,567	
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources	\$3,372	\$1,942
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	\$2,934	\$1,752
Net Cost of Operations	\$(23,666)	\$(22,031)

The accompanying notes are an integral part of these statements.

**NOTES TO PRINCIPAL FINANCIAL STATEMENTS  
FOR THE YEARS ENDED SEPTEMBER 30, 2004 AND 2003**

---

## **Note 1. Summary of Significant Accounting Policies**

### **Reporting Entity**

Federal Student Aid (FSA) was created as a Performance Based Organization (PBO) within the U.S. Department of Education (the Department) under the Higher Education Act of 1965, as amended (HEA), from previously existing Department student financial assistance programs. FSA operates under the PBO mandate to develop a management structure driven by strong incentives to manage for results. FSA's primary goal is to assist lower-income and middle-income students in overcoming the financial barriers that make it difficult to attend and complete postsecondary education. It is responsible for administering direct loans, guaranteed loans, and grant programs.

The Federal Direct Student Loan Program, authorized by the Student Loan Reform Act of 1993, enables FSA to make loans directly to eligible undergraduate and graduate students and their parents through participating schools. FSA borrows money from Treasury to fund the loans. The program provides interest subsidies for eligible borrowers.

The Federal Family Education Loan (FFEL) Program, authorized by the HEA, cooperates with state and private nonprofit Guaranty Agencies to provide loan guarantees and interest subsidies on loans made by private lenders to eligible students.

The Grant Programs, consisting of Pell Grant and Campus-Based Student Aid Programs, enables FSA to provide educational grants and other financial assistance to eligible applicants, which are not repaid by students to the federal government. The Pell Grant Program provides grant aid to low-income and middle-income undergraduate students. Awards vary in proportion to the financial circumstances of students and their families. The Campus-Based Student Aid Programs provide educational grants and other financial assistance to eligible applicants. These programs include the Supplemental Educational Opportunity Grant, Work-Study, and Perkins Loan. Campus-Based programs are not material to these statements and have been included with other programs reported under Grants.

### **Basis of Accounting and Presentation**

These consolidated financial statements have been prepared to report the financial position, net cost of operations, changes in net position, budgetary resources, and financing of the Federal Student Aid reporting group, as required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. The financial statements were prepared from the books and records of FSA, in accordance with accounting principles generally accepted (GAAP) in the United States of America and Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*. GAAP for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), which is the official standard setting body for the federal government. These financial statements are different from the financial reports prepared by the Department pursuant to OMB directives that are used to monitor and control FSA's use of budgetary resources.

The financial statements should be read with the realization they represent the reporting group, FSA, within the Department of Education. One implication of this is that liabilities cannot be liquidated without legislation providing resources and legal authority to do so.

The accounting structure of federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds.

## **Use of Estimates**

The preparation of the financial statements in accordance with generally accepted accounting principles in the United States requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements. Actual results may differ from those estimates.

Estimates for credit program receivables and liabilities contain assumptions that have a significant impact on the financial statements. The primary components of this assumption set include, but are not limited to, collections (including loan consolidations), repayments, default rates, prevailing interest rates and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these assumption components may create significant changes to the estimate.

FSA and the Department recognize the sensitivity of the changes in assumptions and the impact that the projections can have on estimates. Management has attempted to mitigate these fluctuations by using trend analysis to project future cash flows. The assumptions used for the September 30, 2004 and 2003, financial statements are based on the best information available at the time the estimate was derived.

Changes in assumptions could significantly affect the amounts reflected in these statements. For example, a long-term change in the projected interest rate charged to borrowers could change the current subsidy re-estimate by a significant amount.

The Student Loan Model (SLM) and estimating methods used are updated periodically to reflect changing conditions. The SLM was the official estimating model of the Department as of September 30, 2004 and 2003, and was used to calculate the subsidy re-estimates recorded in these financial statements.

## **Budget Authority**

Budget authority is the authorization provided by law for the Department and FSA to incur financial obligations that will result in outlays. FSA's budgetary resources for fiscal years 2004 and 2003 included (1) unobligated balances of resources from prior years, (2) recoveries of obligations in prior years, and (3) new resources—appropriations, authority to borrow from the U.S Department of Treasury (Treasury), and spending authority from collections. Unobligated balances associated with resources expiring at the end of the fiscal year remain available for five years after expiration only for upward adjustments of prior-year obligations, after which they are canceled and may not be used. Unobligated balances of resources that have not expired at year-end may have new obligations placed against them, as well as net upward adjustments of prior-year obligations.

Treasury Debt provides most of the funding for the loan principal disbursements made under the Federal Direct Student Loan Program. Subsidy and administrative costs of the program are funded by appropriations. Budgetary resources from collections are used primarily to repay the FSA's debt to Treasury. Major sources of collections

include (1) principal and interest collections from borrowers or through the consolidation of loans to borrowers, (2) related fees, and (3) interest from Treasury on balances in certain credit accounts that make and administer loans and guarantees.

### **Fund Balance with Treasury**

FSA maintains cash accounts with Treasury. The fund balance with Treasury includes appropriated and revolving funds available to pay current liabilities and finance authorized purchases, as well as funds restricted until future appropriations are received. Treasury processes the cash receipts and cash disbursements for FSA. FSA's records are reconciled with those of Treasury. (See Note 2.)

### **Cash and Other Monetary Assets**

Cash and other monetary assets consist of Guaranty Agency reserves and deposits in transit. Guaranty Agency reserves represent FSA's interest in the net assets of the FFEL program Guaranty Agencies. Guaranty Agency reserves are classified as non-entity assets with the public (see Note 3) and are offset by a corresponding liability due to Treasury. Guaranty Agency reserves include initial federal start-up funds (Guaranty Agency advances), receipts of federal reinsurance payments, insurance premiums, Guaranty Agency share of collections on defaulted loans, investment income, administrative cost allowances, and other assets purchased out of reserve funds.

Section 422A of the HEA required FFEL Guaranty Agencies to establish a Federal Student Loan Reserve Fund (the "Federal Fund") and an Operating Fund by December 6, 1998. The Federal Fund and the non-liquid assets developed or purchased by a Guaranty Agency as a result, in whole or in part with federal funds, are the property of the United States. However, such ownership by FSA is independent of the actual control of the assets.

FSA disburses funds to the Guaranty Agency through the Federal Fund to pay lender claims and default aversion fees of a Guaranty Agency. The Operating Fund is the property of the Guaranty Agency except for funds an agency borrows from the Federal Fund (under Section 422A of the HEA). The Operating Fund is used by the Guaranty Agency to fulfill its responsibilities. These responsibilities include repaying money borrowed from the Federal Fund, default aversion and collection activities.

### **Accounts Receivable**

Accounts receivable are amounts due to FSA from the public and other federal agencies. Receivables from the public typically result from such items as overpayments of educational assistance, whereas amounts due from other federal agencies result from agreements entered into by FSA with these agencies for various goods and services. Accounts receivable are recorded at cost less an allowance for uncollectible amounts. (See Note 5.)

### **Credit Program Receivables and Liabilities for Loan Guarantees**

The financial statements at September 30, 2004 and 2003, reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the Federal Credit Reform Act of 1990 (the Act). Loans and interest receivable are valued at their gross amounts less an allowance for the present value of the amounts not expected to be recovered and thus having to be subsidized—called "allowance for subsidy." The difference is the present value of the cash flows to and from FSA that are expected from the receivables over their expected lives. Similarly, liabilities for loan guarantees are valued at the present value of the cash outflows from FSA less the present value of

related inflows. The estimated present value of net long-term cash outflows of FSA for subsidized costs (primarily defaults) is net of recoveries, interest supplements, and offsetting fees. FSA records all credit program loans and loan guarantees at their present values.

Components of subsidy costs involved with loans and guarantees include defaults, net of recoveries, contractual payments to third-party private loan collectors who receive a set percentage of amounts they collect, and, as an offset, application and other fees to be collected. For direct loans, the difference between interest rates incurred by the Department and FSA on its borrowings from Treasury and interest rates charged to target groups is also subsidized (or may provide an offset to subsidy if the Department's rate is less). The corresponding interest subsidy in loan guarantee programs is the payment of interest supplements to third-party lenders in order to buy down the interest rates on loans made by those lenders. Subsidy costs are recognized when direct loans or guaranteed loans are disbursed to borrowers and are re-estimated each year. (See Note 4.)

## **General Property, Plant and Equipment**

In accordance with the Department policy, FSA capitalizes single items of property and equipment with a cost of \$50,000 or more that have an estimated useful life greater than two years. Additionally, FSA capitalizes bulk purchases of property and equipment with an aggregate cost of \$500,000 or more. A bulk purchase is defined as the purchase of like items related to a specific project or the purchase of like items occurring within the same fiscal year that have an estimated useful life greater than two years. Property and Equipment are depreciated over their estimated useful lives using the straight-line method of depreciation. Internal Use Software (IUS) meeting the above cost and useful life criteria is also capitalized. IUS is software purchased off the shelf, internally developed, or contractor developed solely to meet the agency's internal needs.

The Department adopted the following useful lives for the major classes of depreciable property and equipment:

<b>Major Classes of Depreciable Property and Equipment</b>	<b>Years</b>
Information Technology (IT), Internal Use Software (IUS) and Telecommunications equipment	3
Furniture and Fixtures	5

## **Liabilities**

Liabilities represent actual and estimated amounts likely to be paid as a result of transactions or events that have already occurred. However, no liabilities can be paid by FSA or the Department without an appropriation or other collection of revenue for services provided. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources, and there is no certainty the appropriation will be enacted. Liabilities of FSA and the Department arising from other than contracts can be abrogated by the government acting in its sovereign capacity. FFEL and Federal Direct Student Loan Program liabilities are entitlements covered by permanent indefinite budget authority enacted as of year-end.

## **Treasury Debt**

The amount shown for the liability to Treasury from borrowings represents unpaid principal owing on the loans at year-end associated with FSA's direct loan activities. FSA repays the loan principal based on available fund balances. Interest on the debt is calculated at fiscal year-end using rates set by Treasury, with such rates generally



fixed based on the rate for 10-year securities. As discussed in Note 4, the interest received by FSA from borrowers will vary from the rate paid to the Treasury. Principal and interest payments are made annually. (See Note 6.)

## **Accrued Grant Liability**

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. A liability is accrued by FSA for expenditures incurred by grantees prior to receiving grant funds for the expenditures. The amount is estimated using statistical sampling techniques. (See Note 10.)

## **Net Position**

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances of appropriations, except those for federal credit financing and liquidating funds. Cumulative results of operations represent the net difference since inception between (1) expenses and (2) revenues and financing sources. (See Note 11.)

## **Personnel Compensation and Other Employee Benefits**

**Annual, Sick and Other Leave.** The liability for annual leave, compensatory time off, and other leave is accrued when earned and reduced when taken. Each year, the accrued annual leave account balance is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

**Retirement Plans and Other Employee Benefits.** Employees participate either in the Civil Service Retirement System (CSRS), a defined benefit plan, or in the Federal Employees Retirement System (FERS), a defined benefit and contribution plan. For CSRS employees, the Department contributes a fixed percentage of pay. For FERS employees, the Department contributes fixed percentages to both a defined benefits plan and a defined contributions plan (Thrift Savings Plan). For FERS employees, the Department also contributes the employer's share for Social Security (FICA) and Medicare.

The FERS program is fully funded by agency and worker contributions. Such contributions for other retirement plans and benefits are insufficient to fully fund the programs, which are subsidized by the Office of Personnel Management (OPM). The Department imputes its share of the OPM subsidy, using cost factors OPM provides, and reports the full cost of the programs related to its employees.

**Federal Employees Compensation Act.** The Federal Employees Compensation Act (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (Labor), which pays valid claims and subsequently seeks reimbursement from the Department for these paid claims.

The FECA liability consists of two components. The first component is based on actual claims paid by Labor but not yet reimbursed by the Department. The Department reimburses Labor for the amount of actual claims as funds are appropriated for this purpose. There is generally a two to three year time period between payment by Labor and

reimbursement to Labor by the Department. As a result, the Department recognizes a liability for the actual claims paid by Labor and to be reimbursed by the Department.

The second component is the estimated liability for future benefit payments as a result of past events. This liability includes death, disability, medical and miscellaneous costs. Labor determines this component annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. The projected annual benefit payments are discounted to present value using the Office of Management and Budget economic assumptions for 10-year Treasury notes and bonds. To provide for the effects of inflation on the liability, wage inflation factors (i.e., cost of living adjustments) and medical inflation factors (i.e., consumer price index medical adjustments) are applied to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments and to adjust future benefit payments to current-year constant dollars. A discounting formula is also used to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

Labor evaluates the estimated projections to ensure that the resulting projections were reliable. The analysis includes two tests: (1) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments, and (2) a comparison of the ratio of the estimated liability to the actual payment of the beginning year calculated for the current projection to the liability-payment ratio calculated for the prior projection.

A portion of the estimated liability for disability benefits assigned to the Department under the Federal Employees Compensation Act (FECA) is accrued by FSA. The accrual is based on the present value of estimated net future payments by the Department of Labor, which administers the FECA program.

### **Intragovernmental Transactions**

FSA's financial activities interact and are dependent upon the financial activity of the centralized management functions of the federal government. FSA is subject to financial regulation and management control by the Office of Management and Budget and Treasury. As a result of this relationship, operations may not be conducted and financial positions may not be reported as they would if FSA were a separate, unrelated entity.

## Note 2. Fund Balance with Treasury

Fund balance with Treasury at September 30, 2004 and 2003, consisted of the following:

<b><u>(Dollars in Millions)</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
Appropriated Funds	\$ 10,326	\$ 11,544
Revolving Funds	17,009	11,185
Other Funds	8	7
<b>Total Fund Balance with Treasury</b>	<b>\$ 27,343</b>	<b>\$ 22,736</b>

<b>Status of Fund Balance with Treasury</b>		
<b><u>(Dollars in Millions)</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
Unobligated Balance		
- Available	\$ 1,010	\$ 444
- Unavailable	14,645	10,533
Obligated Balance, Not Yet Disbursed	11,680	11,752
Other Funds	8	7
<b>Total Status of Fund Balance with Treasury</b>	<b>\$ 27,343</b>	<b>\$ 22,736</b>

Fund Balance with Treasury is an entity asset maintained with Treasury. The monies are available to pay current liabilities and finance loan programs. The Department has the authority to disburse funds to agencies and institutions participating in its programs through the Treasury, which processes cash receipts and disbursements on its behalf.

Revolving funds conduct continuing cycles of business-like activity and do not require an annual appropriation. Their fund balance comes from collections (other federal entities and the public) and from borrowings. Other funds primarily consist of suspense, deposit funds and clearing accounts.

Available unobligated balances represent amounts that are apportioned for obligation in the current fiscal year. Unavailable unobligated balances represent amounts that are not apportioned for obligation during the current fiscal year and expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include reimbursements and other income earned, undelivered orders and expended authority-unpaid.

### Note 3. Cash and Other Monetary Assets

Cash and Other Monetary Assets consisted of Guaranty Agency reserves (non-entity assets) and deposits in transit as of September 30, 2004 and 2003.

<u>(Dollars in Millions)</u>	2004		
	Guaranty Agency Reserves	Deposits in Transit	Total
Beginning Balance, September 30	\$ 1,107	\$ -	\$ 1,107
Current Year Activity	(67)	-	(67)
Ending Balance, September 30	<u>\$ 1,040</u>	<u>\$ -</u>	<u>\$ 1,040</u>

<u>(Dollars in Millions)</u>	2003		
	Guaranty Agency Reserves	Deposits in Transit	Total
Beginning Balance, September 30	\$ 1,169	\$ 36	\$ 1,205
Current Year Activity	(62)	(36)	(98)
Ending Balance, September 30	<u>\$ 1,107</u>	<u>\$ -</u>	<u>\$ 1,107</u>

Guaranty Agency reserves are collected and held on behalf of the U.S. government, a liability due to Treasury and considered intragovernmental liabilities. These balances represent the federal government's interest in the net assets of state and nonprofit FFEL Program Guaranty Agencies. (See Note 1.)

On September 30, 2004 and 2003, Guaranty Agencies held approximately \$1,040 million and \$1,107 million in federal assets, respectively. The agencies use the funds to pay lender claims, primarily for loan defaults and discharges. Consistent with Section 422A(e) of the HEA, these funds are considered "property of the United States" and are reflected in the *Budget of the United States Government*.

## **Note 4. Credit Program Receivables and Liabilities for Loan Guarantees**

The Department operates the William D. Ford Direct Student Loan and Federal Family Education Loan (FFEL) programs to help students finance the costs of higher education. Under the programs, the Department makes loans directly or guarantees all or a portion of loans made by participating lending institutions to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education—public and private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents receive loans regardless of income or credit rating; student borrowers who demonstrate financial need also receive federal interest subsidies.

Under the Direct Loan program, the federal government makes loans directly to students and parents through participating schools. Loans are originated and serviced through contracts with private vendors. Under the FFEL program, more than 3,400 financial institutions make loans directly to students and parents. FFEL loans are guaranteed by the federal government against default, with 36 state or private nonprofit Guaranty Agencies acting as intermediaries in administering the guarantees. Beginning with loans first disbursed on or after October 1, 1993, financial institutions became responsible for two percent of the cost of each default. Guaranty Agencies also began paying a portion of the cost (in most cases, five percent) of each defaulted loan from federal funds they hold in trust. FFEL lender participants receive statutorily set federal interest and special allowance subsidies; Guaranty Agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The Federal Credit Reform Act of 1990 (the Act) underlies the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees, other than for general administration of the programs, is referred to as “subsidy cost.” Under the Act, subsidy costs for loans obligated beginning in FY 1992 are the net present value of projected lifetime costs in the year the loan is disbursed. Subsidy costs are revalued annually through the re-estimate process.

The Department estimates all future cash flows associated with Direct Loans and FFEL. Projected cash flows are used to develop subsidy estimates. Subsidy costs can be positive or negative; negative subsidies occur when expected program inflows of cash (e.g., repayments and fees) exceed expected outflows. Subsidy is recorded as the initial amount of the loan guarantee liability when guarantees are made—the loan liability—and as a valuation allowance to government-owned loans and interest receivable (i.e., direct and defaulted guaranteed loans).

The Department uses a computerized cash flow projection Student Loan Model (SLM) to calculate subsidy estimates for Direct Loans and guaranteed FFEL program loans. Cash flows are projected over the life of the loan, aggregated by loan type, cohort year, and risk category. The loan’s cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary (for-profit) schools.

The estimates reflected in these statements were prepared using assumptions developed for the FY 2005 Mid-Session Review, a governmentwide exercise required annually by the OMB. These estimates are the most current available to the Department at the time the financial statements are prepared. Department management has a

process to review these estimates in the context of subsequent changes in assumptions, and reflect the impact of these changes as appropriate.

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. Under the Act and requirements provided by OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, the retirement of loans being consolidated is considered a receipt of principal and interest; this receipt is offset by the disbursement related to the newly created consolidation loan. The underlying direct or guaranteed loans, whether performing or non-performing, in any given cohort are paid off in their original cohort and new loans are opened in the cohort in which consolidation activity occurs. This consolidation activity is taken into consideration in establishing the subsidy rate for defaults.

The FFEL estimated liability for loan guarantees is reported as the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and cancellations. The same methodology is used to estimate the allowance on Direct Loans receivables.

The Department disbursed approximately \$20 billion in Direct Loans to eligible borrowers in FY 2004 and approximately \$18 billion in FY 2003. Half of all loan volume is obligated in the fourth quarter of the fiscal year. Loans typically disburse in multiple installments over an academic period; as a result, loan disbursements for an origination cohort year often cross fiscal years. Regardless of the fiscal year in which they occur, disbursements are tracked by the cohort to which they belong, which is determined by the time of obligation rather than disbursement.

As of September 30, 2004 and 2003, the total principal balances outstanding of guaranteed loans held by lenders were approximately \$245 billion and \$213 billion, respectively. As of September 30, 2004 and 2003, the estimated maximum government exposure on outstanding guaranteed loans held by lenders was approximately \$240 billion and \$209 billion, respectively. Of the insured amount, the Department would pay a smaller amount to the Guaranty Agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the Guaranty Agencies from their federal funds. Payments by Guaranty Agencies do not reduce government exposure because they are made from federal funds administered by the agencies.

The Department accrues interest receivable and records interest revenue on its performing direct loans. Given the Department's substantial collection rates, interest receivable is also accrued and interest revenue recognized on defaulted direct loans. Guaranteed loans that default are initially turned over to Guaranty Agencies for collection, and interest receivable is accrued and recorded on the loans as the collection rate is substantial. After approximately four years, defaulted guaranteed loans not in repayment are turned over to the Department for collection; accrued interest is calculated but only realized upon collection. Interest income is recognized for performing and defaulted direct loans. The Department does not record interest income on defaulted guaranteed loans; all borrower interest actually or expected to be accrued or received is used in estimating the FFEL liability for loss and allowance for subsidy.

As previously noted, borrowers may prepay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan. The loan liability and net receivables include estimates of future prepayments of existing loans; they do not reflect costs associated with anticipated future consolidation loans.

Due to the nature of the loan commitment process in which schools establish a loan commitment with the filing of an aid application, which may occur before a student has been accepted by the school or begins classes, approximately seven percent of loan commitments are never disbursed. For Direct Loans committed in FY 2004, an estimated \$1.3 billion will not be disbursed; for guaranteed loans committed in FY 2004, an estimated \$6.3 billion will not be disbursed. Direct Loan schools may originate loans through a cash advance from the Department, establishing a loan receivable, or by advancing their own funds in anticipation of reimbursement from the Department.



## Credit Program Receivables, Net

The Credit Program Receivables, Net consisted of the following program loans:

<i><b>(Dollars in Millions)</b></i>	<b>2004</b>	<b>2003</b>
Direct Loan Program Loan Receivables, Net	\$ 93,747	\$ 86,634
FFEL Program Loan Receivables, Net	10,671	10,786
Perkins Program Loan Receivables, Net	194	195
<b>Credit Program Receivables, Net</b>	<b>\$ 104,612</b>	<b>\$ 97,615</b>

The following schedules summarize the direct and defaulted FFEL loan principal and related interest receivable, net or inclusive of the allowance for subsidy.

<b>Direct Loan Program Receivables</b>		
<i><b>(Dollars in Millions)</b></i>	<b>2004</b>	<b>2003</b>
Principal Receivable	\$ 89,245	\$ 84,520
Interest Receivable	2,858	2,771
<b>Receivables</b>	<b>92,103</b>	<b>87,291</b>
Less: Allowance for Subsidy	(1,644)	657
<b>Credit Program Receivables, Net</b>	<b>\$ 93,747</b>	<b>\$ 86,634</b>

Of the \$92.1 billion in Direct Loan receivables as of September 30, 2004, \$6.3 billion are currently in default and held at the Department's Borrowers Services Collections Group. As of September 30, 2003, \$5.6 billion were in default and held at the Department's Borrowers Services Collections Group out of a total receivable of \$87.3 billion.

<b>FFEL Program Receivables</b>						
<i><b>(Dollars in Millions)</b></i>	<b>2004</b>			<b>2003</b>		
	<b>Pre-1992</b>	<b>Post-1991</b>	<b>Total</b>	<b>Pre-1992</b>	<b>Post-1991</b>	<b>Total</b>
Principal Receivable	\$ 10,324	\$ 7,247	\$ 17,571	\$ 10,555	\$ 7,119	\$ 17,674
Interest Receivable	857	1,580	2,437	1,144	1,553	2,697
<b>Receivables</b>	<b>11,181</b>	<b>8,827</b>	<b>20,008</b>	<b>11,699</b>	<b>8,672</b>	<b>20,371</b>
Less: Allowance for Subsidy	7,921	1,416	9,337	8,273	1,312	9,585
<b>Credit Program Receivables, Net</b>	<b>\$ 3,260</b>	<b>\$ 7,411</b>	<b>\$ 10,671</b>	<b>\$ 3,426</b>	<b>\$ 7,360</b>	<b>\$ 10,786</b>

## Direct Loan Program Reconciliation of Allowance for Subsidy

The reconciliation of allowance for subsidy for the Direct Loan Program follows:

<b><i>(Dollars in Millions)</i></b>	<b>2004</b>	<b>2003</b>
<b>Beginning Balance, Allowance for Subsidy</b>	<b>\$ 657</b>	<b>\$ (2,115)</b>
<b>Components of Subsidy Transfers</b>		
Interest Rate Differential	(1,276)	(1,724)
Defaults, Net of Recoveries	390	613
Fees	(401)	(377)
Other	1,117	1,122
<b>Current Year Subsidy Transfers</b>	<b>(170)</b>	<b>(366)</b>
<b>Components of Subsidy Re-estimates</b>		
Interest Rate Re-estimates <sup>1</sup>	(1,526)	388
Technical and Default Re-estimates	1,153	4,694
<b>Total Subsidy Re-estimates</b>	<b>(373)</b>	<b>5,082</b>
<b>Activity</b>		
Fee Collections	450	408
Loan Cancellations <sup>2</sup>	(92)	(104)
Subsidy Allowance Amortization	(1,815)	(1,953)
Other	(301)	(295)
<b>Total Activity</b>	<b>(1,758)</b>	<b>(1,944)</b>
<b>Ending Balance, Allowance for Subsidy</b>	<b>\$ (1,644)</b>	<b>\$ 657</b>

<sup>1</sup> The interest rate re-estimate relates to subsidy associated with establishing a fixed rate for the Department's borrowing from Treasury.

<sup>2</sup> Loan cancellations include write-offs of loans because the primary borrower died, became disabled, or declared bankruptcy.

## FFEL Program Reconciliation of Liabilities for Loan Guarantees

Liabilities for Loan Guarantees represent the present value of future projected cash outflows from the Department, net of inflows, such as fees, and collection of principal and interest on defaulted guaranteed loans assumed for direct collection.

The FFEL Program Liability for Loan Guarantees reconciliation is associated with the FFEL Program loans guaranteed in the financing account. The FFEL liquidating account liability for loan guarantees is included in the total Liabilities for Loan Guarantees.

<u>(Dollars in Millions)</u>	<u>2004</u>	<u>2003</u>
<b>Beginning Balance, Liability for Loan Guarantees</b>	<b>\$ 15,310</b>	<b>\$ 11,571</b>
<b>Components of Subsidy Transfers</b>		
Interest Supplement Costs <sup>1</sup>	10,087	5,569
Defaults, Net of Recoveries	888	1,398
Fees	(4,230)	(3,181)
Other <sup>2</sup>	2,151	2,087
<b>Current Year Subsidy Transfers</b>	<b>8,896</b>	<b>5,873</b>
<b>Components of Subsidy Re-estimates</b>		
Interest Rate Re-estimates	70	4
Technical and Default Re-estimates	(1,449)	(2,534)
<b>Subsidy Re-estimates in Liability</b>	<b>(1,379)</b>	<b>(2,530)</b>
<b>Activity</b>		
Interest Supplement Payments	(2,345)	(2,088)
Claim Payments	(2,803)	(2,834)
Fee Collections	2,588	2,025
Interest on Liability Balance	436	458
Other <sup>3</sup>	2,511	2,835
<b>Total Activity</b>	<b>387</b>	<b>396</b>
<b>Ending Balance, Liability for Loan Guarantees</b>	<b>23,214</b>	<b>15,310</b>
FFEL Liquidating Account Liability for Loan Guarantees	115	122
<b>Total Liabilities for Loan Guarantees</b>	<b>\$ 23,329</b>	<b>\$ 15,432</b>

<sup>1</sup> Increase in 2004 primarily results from costs associated with increased consolidation loan volume.

<sup>2</sup> Subsidy primarily associated with debt collections and loan cancellations due to death, disability, and bankruptcy.

<sup>3</sup> Activity primarily associated with the transfer of subsidy for defaults; loan consolidation activity; and loan cancellations due to death, disability, and bankruptcy.

## Subsidy Expense

Direct Loan and FFEL program subsidy expenses were as follows:

<b>Direct Loan Program Subsidy Expense</b>		
<b><u>(Dollars in Millions)</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>Components of Current-Year Subsidy Transfers</b>		
Interest Rate Differential	\$ (1,276)	\$ (1,724)
Defaults, Net of Recoveries	390	613
Fees	(401)	(377)
Other	1,117	1,122
<b>Current Year Subsidy Transfers</b>	<b>(170)</b>	<b>(366)</b>
Re-estimates	(373)	5,082
<b>Direct Loan Subsidy Expense</b>	<b>\$ (543)</b>	<b>\$ 4,716</b>

Direct Loan subsidy expense was reduced by \$373 million by the 2004 re-estimates. The re-estimate related to changes in actual and forecasted interest rates reduced subsidy expense by \$847 million. The re-estimate related to changes in assumptions for other variables, such as assumed term and maturity, loan volume, and prepayment rates increased subsidy expense by \$474 million. A one percent increase in projected borrower base rates would reduce projected Direct Loan costs by \$775 million.

<b>FFEL Program Loan Guarantee Subsidy Expense</b>		
<b><u>(Dollars in Millions)</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>Components of Current-Year Subsidy Transfers</b>		
Interest Supplement Costs	\$ 10,087	\$ 5,569
Defaults, Net of Recoveries	888	1,398
Fees	(4,230)	(3,181)
Other	2,151	2,087
<b>Current Year Subsidy Transfers</b>	<b>8,896</b>	<b>5,873</b>
Re-estimates	(380)	(3,365)
<b>FFEL Loan Guarantee Subsidy Expense</b>	<b>\$ 8,516</b>	<b>\$ 2,508</b>

FFEL subsidy expense was reduced by \$380 million by the 2004 re-estimates. The re-estimate related to changes in actual and forecasted interest rates reduced subsidy expense by \$352 million. The re-estimate related to changes in assumptions for other variables, such as assumed term and maturity, loan volume, and prepayment rates reduced subsidy expense by \$28 million. A one percent increase in borrower interest rates and the guaranteed yield for lenders would increase projected FFEL costs by \$4.2 billion.

## Subsidy Rates

The subsidy rates applicable to the 2004 loan cohort year were as follows:

<b>Subsidy Rates - Cohort 2004</b>					
	<b>Interest Differential</b>	<b>Defaults</b>	<b>Fees</b>	<b>Other</b>	<b>Total</b>
Direct Loan Program	(5.65%)	1.74%	(1.97%)	5.26%	(0.62%)
	<b>Interest Supplements</b>	<b>Defaults</b>	<b>Fees</b>	<b>Other</b>	<b>Total</b>
FFEL Program	13.33%	1.06%	(5.56%)	2.78%	11.61%

The subsidy rates disclosed pertain only to the cohort listed. These rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the Department or third-party lenders disburse guaranteed loans. The costs of the Department's student loan programs, and especially the Direct Loan program, are highly sensitive to changes in actual and forecasted interest rates. Rates are established in statute; the existing loan portfolio has a mixture of borrower and lender rate formulae. Governmentwide interest rate projections are developed by the President's Office of Management and Budget.

New student and parent loans have variable interest rates, reset annually. The federal capital for Direct Loans is provided annually by the Treasury at a fixed interest rate. Borrowers may consolidate outstanding loans into a single loan with a fixed interest rate based on the interest rates of the original loans. Borrower interest rates differ from the rate at which the Department borrows from Treasury. When developing subsidy cost estimates, the Department considers the impact of future interest rate changes on program costs and as part of the re-estimate process, annually adjusts subsidy costs. Changes in interest rate assumptions decreased the re-estimate for Direct Loans by \$847 million in 2004 and increased the re-estimate by \$1.3 billion in 2003. For FFEL, interest rates assumption changes reduced the re-estimate by \$352 million and \$768 million in 2004 and 2003, respectively.

## Administrative Expenses

The administrative expenses for Direct Loan and FFEL Programs were as follows:

	<b>2004</b>		<b>2003</b>	
<b><u>(Dollars in Millions)</u></b>	<b><u>Direct Loan</u></b>	<b><u>FFEL</u></b>	<b><u>Direct Loan</u></b>	<b><u>FFEL</u></b>
Operating Expense	\$ 409	\$ 281	\$ 358	\$ 271
Other Expense	10	-	10	2
<b>Total Administrative Expenses</b>	<b>\$ 419</b>	<b>\$ 281</b>	<b>\$ 368</b>	<b>\$ 273</b>

## Perkins Loan Program

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. For each fiscal year 2004 and 2003, the Department provided capital contributions of \$99 million used to make loans to eligible students through participating schools at five percent interest. For certain defaulted loans, the Department reimburses the originating school and collects from the borrowers. At September 30, 2004 and 2003, loans receivable, net of an allowance for loss, was \$194 million and \$195 million, respectively. These loans, originally disbursed as grants, are valued at historical cost.

## Note 5. Accounts Receivable

Accounts receivable consisted of the following at September 30, 2004 and 2003:

<u>(Dollars in Millions)</u>	2004		
	Gross Receivables	Allowance	Net Receivables
Intragovernmental	\$ -	\$ -	\$ -
With the Public	178	(37)	141
<b>Total Accounts Receivable</b>	<b>\$ 178</b>	<b>\$ (37)</b>	<b>\$ 141</b>

<u>(Dollars in Millions)</u>	2003		
	Gross Receivables	Allowance	Net Receivables
Intragovernmental	\$ -	\$ -	\$ -
With the Public	186	(32)	154
<b>Total Accounts Receivable</b>	<b>\$ 186</b>	<b>\$ (32)</b>	<b>\$ 154</b>

Accounts receivable represent balances due from recipients of grant and other financial assistance programs, and reimbursable agreements from other federal agencies. They are recorded at their estimated net realizable value. Estimates for the allowance for loss on uncollectible accounts are based on historical data.

## Note 6. Treasury Debt

At September 30, 2004 and 2003, FSA's Debt to the Treasury was \$96,421 million and \$91,787 million, respectively. The table below depicts the change in debt from October 1, 2003 to September 30, 2004 and October 1, 2002 to September 30, 2003.

<u>(Dollars in Millions)</u>	<u>2004</u>	<u>2003</u>
Beginning Balance	\$ 91,787	\$ 89,498
Accrued Interest	1	-
New Borrowing	21,191	19,637
Repayments	<u>(16,558)</u>	<u>(17,348)</u>
<b>Ending Balance</b>	<b><u>\$ 96,421</u></b>	<b><u>\$ 91,787</u></b>

Funds were borrowed to provide funding for direct loans to students.

The level of repayments on borrowings to Treasury is derived from many factors:

- Beginning-of-the-year cash balance, collections, borrowings, interest revenue, disbursements, and interest expense have an impact on the available cash to repay Treasury.
- Cash is held to cover future liabilities, such as contract collection costs and disbursements in transit.

## Note 7. Payable to Treasury

At September 30, 2004 and 2003, Payable to the Treasury for estimated liquidating fund future cash inflows in excess of outflows and for downward re-estimates of subsidy, is shown in the table below.

<u>(Dollars in Millions)</u>	<u>2004</u>	<u>2003</u>
Future Liquidating Account Collections, Beginning Balance	\$ 3,761	\$ 2,007
Valuation of Pre-92 Loan Liability and Allowance	847	3,542
Capital Transfers to Treasury	<u>(1,117)</u>	<u>(1,788)</u>
<b>Future Liquidating Account Collections, Ending Balance</b>	<b><u>3,491</u></b>	<b><u>3,761</u></b>
FFEL Downward Subsidy Re-estimate	<u>1,502</u>	<u>3,262</u>
<b>Total Payable to Treasury</b>	<b><u>\$ 4,993</u></b>	<b><u>\$ 7,023</u></b>

In accordance with the Credit Reform Act, the liquidating fund pays monies to Treasury each year based on available fund balances, and the FFEL financing fund pays the liability related to downward subsidy re-estimates, upon budget execution.



## Note 8. Other Liabilities

Other liabilities include current liabilities for contractual services, administrative services, deferred credits, liability for deposit funds, contingent liabilities, custodial liabilities, and the liability for unfunded accrued annual leave. Additionally, the non-current liabilities include accrued unfunded FECA. Other liabilities consisted of the following at September 30, 2004 and 2003:

<b><u>(Dollars in Millions)</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>Intragovernmental</b>		
Accrued Unfunded FECA Liability	\$ 1	\$ 1
<b>Total Intragovernmental</b>	<b>1</b>	<b>1</b>
<b>With the Public</b>		
Accrued Payroll and Benefits	4	3
Accrued Unfunded Annual Leave	7	7
Custodial Liability	194	195
Deferred Credits	1	7
Liability for Deposit Funds	8	8
Other Liabilities	59	100
<b>Total With the Public</b>	<b>273</b>	<b>320</b>
<b>Total Other Liabilities</b>	<b>\$ 274</b>	<b>\$ 321</b>

## Note 9. Liabilities Not Covered by Budgetary Resources

Liabilities on FSA's Balance Sheet as of September 30, 2004 and 2003, include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely and anticipated, it is not certain that appropriations will be enacted to fund these liabilities. Liabilities not covered by budgetary resources consisted of the following at September 30, 2004 and 2003:

<b><u>(Dollars in Millions)</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>Intragovernmental</b>		
Accrued Unfunded FECA Liability	\$ 1	\$ 1
<b>Total Intragovernmental</b>	<b>1</b>	<b>1</b>
<b>With the Public</b>		
Custodial Liability	194	195
Accrued Unfunded Annual Leave	7	7
Federal Employee and Veterans' Benefits	4	5
<b>Total With the Public</b>	<b>205</b>	<b>207</b>
<b>Liabilities Not Covered by Budgetary Resources</b>	<b>206</b>	<b>208</b>
<b>Liabilities Covered by Budgetary Resources</b>	<b>126,863</b>	<b>116,221</b>
<b>Total Liabilities</b>	<b>\$ 127,069</b>	<b>\$ 116,429</b>

## Note 10. Accrued Grant Liability

FSA's accrued grant liability was \$637 million as of September 30, 2004 and \$551 million as of September 30, 2003. (See Note 1.)

## Note 11. Net Position

The nature of FSA's net position was discussed in Note 1, and the components are set forth in the Statement of Changes in Net Position. The table below reports the composition of appropriations that have not been used to fund goods and services received or benefits provided as of September 30, 2004 and 2003.

<b><u>(Dollars in Millions)</u></b>	<b><u>2004</u></b>	<b><u>2003</u></b>
Unobligated Balances		
Available	\$ 26	\$ 45
Not Available	198	280
Undelivered Orders	8,957	9,489
<b>Total Unexpended Appropriations</b>	<b><u>\$ 9,181</u></b>	<b><u>\$ 9,814</u></b>

Undelivered orders and unobligated balances for federal credit financing and liquidating funds are not included in the chart above because they are not funded through appropriations. As a result, unobligated and undelivered order balances in the chart above will differ from these balances in the Combined Statement of Budgetary Resources.

FSA had Cumulative Results of Operations of (\$3,062) million as of September 30, 2004, and (\$4,575) million as of September 30, 2003. Cumulative Results of Operations arise from unfunded expenses and capital purchases.

## Note 12. Interest Revenue and Expense

For the Direct Loan Program, non-federal interest revenue is earned on the individual non-defaulted loans in the loan portfolio while federal interest is earned on the uninvested fund balances with Treasury. For the Direct Loan Program, interest expense is incurred on the Department's borrowings from Treasury. For the FFEL program, federal interest revenue is earned on the uninvested fund balance with Treasury in the financing fund.

The interest revenues and expenses directly attributable to the Direct Loan Program and the FFEL Program are summarized below:

	Direct Student Loans		FFEL Program		Total	
<i>(Dollars in Millions)</i>	2004	2003	2004	2003	2004	2003
<b>Interest Revenue:</b>						
Federal	\$ 1,000	\$ 1,076	\$ 436	\$ 458	\$ 1,436	\$ 1,534
Non-federal	4,761	4,954	-	-	4,761	4,954
<b>Total Interest Revenue</b>	<b>\$ 5,761</b>	<b>\$ 6,030</b>	<b>\$ 436</b>	<b>\$ 458</b>	<b>\$ 6,197</b>	<b>\$ 6,488</b>
<b>Interest Expense:</b>						
Federal	\$ 5,761	\$ 6,030	\$ 436	\$ 458	\$ 6,197	\$ 6,488
Non-federal	-	-	-	-	-	-
<b>Total Interest Expense</b>	<b>\$ 5,761</b>	<b>\$ 6,030</b>	<b>\$ 436</b>	<b>\$ 458</b>	<b>\$ 6,197</b>	<b>\$ 6,488</b>

## Note 13. Statement of Budgetary Resources

The Statement of Budgetary Resources (SBR) compares budgetary resources with the status of those resources. As of September 30, 2004, budgetary resources were \$84,202 million and net outlays were \$21,635 million. As of September 30, 2003, budgetary resources were \$74,679 million and net outlays were \$21,141 million.

### Apportionment Categories of Obligations Incurred

FSA receives apportionments of its resources from OMB. Category A apportionments are those for resources that can be obligated without restriction on the purpose of the obligation, other than to be in compliance with legislation underlying programs for which the resources were made available. Category B apportionments are restricted by purpose for which obligations can be incurred. In addition, some resources are available without apportionment by OMB.

The apportionment categories of obligations incurred as of September 30, 2004 and 2003, are summarized below:

<i><u>(Dollars in Millions)</u></i>	<u>2004</u>	<u>2003</u>
Direct and Reimbursable:		
Category A	\$ 719	\$ 685
Category B	66,736	61,847
Exempt from Apportionment	<u>52</u>	<u>63</u>
<b>Total Apportionment Categories of Obligations Incurred</b>	<b><u>\$ 67,507</u></b>	<b><u>\$ 62,595</u></b>

### Permanent Indefinite Budget Authority

The Federal Direct Loan and the Federal Family Education Loan Programs were granted permanent indefinite budget authority through legislation. Part D of the William D. Ford Federal Direct Loan Program and part B of the Federal Family Education Loan Program, pursuant to the HEA, pertains to the existence, purpose, and availability of this permanent indefinite budget authority.

### Reauthorization of Legislation

Funds for most Department of Education programs are authorized, by statute, to be appropriated for a specified number of years, with an automatic one-year extension available under Section 422 of the General Education Provisions Act. Congress may continue to appropriate funds after the expiration of the statutory authorization period, effectively reauthorizing the program through the appropriations process. The current *Budget of the United States Government* presumes all programs continue per congressional budgeting rules.

## Unused Borrowing Authority

FSA is given authority to draw funds from the Treasury to help finance the majority of its direct lending activity in accordance with its needs. Unliquidated Borrowing Authority is considered a budgetary resource and is available to support obligations. FSA periodically reviews its borrowing authority balances and may cancel unused amounts. Unused Borrowing Authority as of September 30, 2004, and 2003, was determined as follows:

<u>(Dollars in Millions)</u>	<u>2004</u>	<u>2003</u>
Beginning Balance, Unused Borrowing Authority	\$ 6,970	\$ 4,934
Current Year Borrowing Authority	22,383	21,726
Funds Drawn From Treasury	(21,191)	(19,637)
Prior Years Unused Borrowing Authority Cancelled	(2,265)	(53)
<b>Ending Balance, Unused Borrowing Authority</b>	<b>\$ 5,897</b>	<b>\$ 6,970</b>

## Comparison to the Budget of the United States Government

Statement of Federal Financial Accounting Standards No. 7 (*SFFAS No. 7*), *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires an explanation of material differences between budgetary resources available, the status of those resources and outlays as presented in the Statement of Budgetary Resources to the related actual balances published in the *Budget of the United States Government (Budget)*. However, the *Budget* has not yet been published. The *Budget* is scheduled for publication in February 2005 and will be available through OMB. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements. There were no material differences between the FY 2003 column on the Statement of Budgetary Resources and the FY 2003 actual amounts reported in the *Budget*.

## **Note 14. Statement of Financing**

The Statement of Financing (SOF) provides information on the total resources used by an agency, both those received through budgetary resources and those received through other means during the reporting period. The statement reconciles these resources with the net cost of operations by (1) removing resources that do not fund net cost of operations and (2) including components of net cost of operations that did not generate or use resources during the year.

The SOF is presented as a consolidated statement for the FSA and its major programs. Net interagency eliminations are presented for proprietary amounts. The budgetary amounts are reported on a combined basis as presented in the Statement of Budgetary Resources. Accordingly, net interagency eliminations for budget amounts are not presented.

The relationship between the amounts reported as liabilities not covered by budgetary resources on the Balance Sheet and amounts reported as components requiring or generating resources in future periods on the Statement of Financing were analyzed. The differences are primarily due to the increase in custodial liability, which does not generate net cost of operations or require the use of budgetary resources.

Other, in the components not requiring or generating resources for FY 2004, is primarily comprised of the subsidy expense recognized in FY 2003 that was not funded in FY 2004 for the Direct Loan program.

## **Note 15. Contingencies**

### **Guaranty Agencies**

The Department can assist Guaranty Agencies experiencing financial difficulties by advancing funds or by other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of Guaranty Agencies because the likelihood of such occurrences is uncertain and cannot be estimated with sufficient reliability.

### **Perkins Loans Reserve Funds**

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In FY 2004, the Department provided funding of 84.8 percent of the capital used to make loans to eligible students through participating schools at five percent interest. The school provided the remaining 15.2 percent of program funding. For the latest academic year ended June 30, 2004, approximately 750,420 loans were made, totaling \$1.6 billion at 1,700 institutions, averaging \$2,161 per loan. The Department's share of the Perkins Loan Program was approximately \$6.5 billion as of June 30, 2004.

In FY 2003, the Department provided funding of 85.2 percent of the capital used to make loans to eligible students through participating schools at five percent interest. The school provided the remaining 14.8 percent of program funding. For the academic year ended June 30, 2003, approximately 763,890 loans were made, totaling \$1.5 billion at 1,742 institutions, averaging \$1,919 per loan. The Department's share of the Perkins Loan Program was approximately \$6.5 billion as of June 30, 2003.

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low-income areas, as a Peace Corps or VISTA volunteer, in the military or in law enforcement, nursing, or family services—may

receive partial loan forgiveness for each year of qualifying service. In these circumstances a contingency is deemed to exist. The Department may be required to compensate Perkins Loan institutions for the cost of the partial loan forgiveness.

### **Litigation and Other Claims**

The Department is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against the Department are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on the Department's financial statements.

### **Other Matters**

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures that were subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Department's financial statements.

# APPENDIX B

## INDEPENDENT AUDITORS REPORT

- *REPORT OF INDEPENDENT AUDITORS*
- *REPORT ON INTERNAL CONTROLS*
- *REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS*







## Report of Independent Auditors

To the Inspector General  
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of FSA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FSA as of September 30, 2004 and 2003, and its net cost, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management Discussion and Analysis of FSA and the Supplemental Information is not a required part of the basic financial statements but is supplementary information required by Office of Management and Budget Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

**Report of Independent Auditors**

Page 2

In accordance with Government Auditing Standards, we have also issued our reports dated November 10, 2004, on our consideration of FSA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audits.



November 10, 2004  
Washington, D.C.

## Report on Internal Control

To the Inspector General  
U.S. Department of Education

We have audited the consolidated balance sheets of the Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department), as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended, and have issued our report thereon dated November 10, 2004.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audits, we considered FSA's internal control over financial reporting by obtaining an understanding of FSA's internal control, determined whether this internal control had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal control relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

In addition, we considered the Department's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal control, determined whether these controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB 01-02 and not to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

Finally, with respect to internal control related to performance measures reported in the Management Discussion and Analysis of FSA's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions.

**Report on Internal Control**

Page 2

Under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 01-02, reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the FSA's ability to record, process, and report financial data consistent with the assertions by management in the financial statements. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We noted certain matters discussed in the following paragraphs involving the internal control and its operation that we consider to be reportable conditions. However, none of the reportable conditions are believed to be material weaknesses. The remainder of this report details the reportable conditions.

FSA relies on the Department's Office of Chief Financial Officer (OCFO) to provide support for FSA's financial reporting needs. Specifically, FSA has a memorandum of understanding (MOU) with OCFO that indicates that OCFO is responsible for the following: (1) preparing FSA's financial statements; (2) performing the daily operations of processing transactions in the general ledger; (3) preparing the required financial reporting to the Office of Management and Budget and the U.S. Department of the Treasury, such as the SF-133 and the SF-224; and (4) developing and distributing accounting policies and procedures.

In addition, under the MOU, FSA is responsible for: (1) implementing accounting policies and procedures; (2) coordinating with OCFO and Budget Service on all financial reporting issues; and (3) reconciling subsidiary ledgers to supporting documentation and ledgers.

**REPORTABLE CONDITIONS****1. Improvements of Credit Reform Estimation and Financial Reporting Processes are Needed (Modified Repeat Condition)**

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements were made over the last several years, we noted that the management controls surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined and implemented earlier in the process to ensure that appropriate estimates are prepared. OMB Circular A-123 defines management controls as "the organization, policies, and

**Report on Internal Control**

Page 3

procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making.”

During FY 2004, we noted that the Department and FSA made significant progress on this reportable condition. Early in FY 2004, the Department created a formal Credit Reform Workgroup (CRW) which consisted of managers from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service. The primary purpose of the CRW was to inform the appropriate parties of key internal issues related to Credit Reform, and manage the development of improved processes, procedures and sources of information to enhance the credit reform estimation process. While the CRW has made progress in many areas, the work is still ongoing. In FY 2005, the Department and FSA will continue to focus on improving and documenting the processes used to arrive at cost estimates. A primary focus for the upcoming fiscal year is to refine the processes used to develop assumptions in the model, that appropriate review procedures are in place within the Budget Service area, and that the entire loan estimation process is documented for transparency. The end objective is a well-defined process, which includes appropriate and robust checks and edits, as well as documentation of key decisions and rationales.

However, after identifying the key improvements made or currently being made by the Department and FSA, during our testing of loan guarantees, allowance for subsidy, and subsidy costs estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long term cost for the Direct Loan (DL) program is reflected on the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the DL receivable. The Department uses a computer-based cash flow projection model (i.e. Student Loan Model or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy account. The model uses multiple sources of loan data and hundreds of assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a “backcast”, which compares the model’s estimates to actual activity for the current and prior fiscal years. After reviewing this “backcast”, we noted that the estimated cash collections developed by the model for the DL program for FY 2004 and prior years were greater than actual collections by a significant amount. The Department has indicated that an increase in deferments/forbearances and income-contingent repayment plans in the DL program are the primary reason for the delay of the actual receipt of payments. The Department is reviewing whether additional sources of information are needed and/or modifications to the assumptions used are required. The output from this new process to model collections will be an important component in the calculations used to determine the net present value of direct loans.



**Report on Internal Control**

Page 4

- A key detection control used by the Department for the loan program estimation process are analytical tools, such as the backcast mentioned above; these tools are used to assess the validity of the estimates derived by the SLM and OMB calculator. One of these analytical tools is the forecast, which illustrates the timing of the estimates of collections or disbursements for the loan program in the years occurring after the current fiscal year. The information for the forecast is derived from data developed directly from the model. As a check, the Department is able to reconcile the total amounts in the forecast to the allowance for subsidy and liability for loan guarantees. However, we noted that some of the analyses prepared by the Department were not appropriately reconciled with one another; specifically for the Federal Family Education Loan (FFEL) program. In order for analytical tools to provide useful information and to serve the purpose as a detection control for the Department such analysis should contain accurate information.
- The early phase of the loan estimation process includes the development of the assumptions, which are used to populate the SLM with data that, in turn, feeds into the OMB calculator which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. During our review of these programs, we noted that the programming language was not documented to explain the procedures executed by the programs. As a result, a review of the logic of these programs cannot be performed by someone unfamiliar with the code, which could have the potential of allowing undetected errors to exist in the development of the assumption data.
- Many phases must be completed before the cost estimates are calculated for the loan programs. Most of these phases occur in the Budget Service area and include the cooperation of mathematicians, statisticians, and economists. During our testing of the various phases of the loan estimation process, we noted that no formal review process was documented for a significant amount of information prepared by the Department and FSA. Further, we noted a calculation error in a spreadsheet that was subsequently adjusted by the Department. We noted that the CRW has begun working on detailed operating procedures for the loan estimation process in FY 2004. Without sufficient documentation of operating and review procedures the loan estimation process may be prone to mechanical and significant errors.
- FFEL program receivables are classified as Pre-1992 loans (liquidating account loans) and Post-1991 loans (financing account loans). The Department records certain collection on each of these loan categories using an estimation process (splitter process) as this information cannot be obtained directly from cash collections. The allocation of collections between liquidating and financing loans ultimately affects the liability account for loan guarantees and accounts payable to treasury. Currently, the Department relies primarily on the output of the credit reform model to record the net value of the Pre-1992 loans. The Department does not currently have a method to be better informed as to

**Report on Internal Control**

Page 5

whether the resulting split is occurring properly on an overall basis. The development of additional analytical tools in this area could provide additional assurance as to whether the model is operating as intended.

**Recommendations:**

We recommend that FSA perform the following:

1. Reassess and modify the model for DL collections, which would appropriately project the timing of estimated collections. These revisions should ensure that collections for all types of payment plans are taken into account when developing cost estimates. Also, evaluate whether additional sources of data are needed for modeling collections. If further alignment of actual and estimated collections is necessary for DL, then appropriate re-estimate adjustments should be developed.
2. Continue to improve the analytical tools used for the loan estimation process. Ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.
3. Document in detail the programs written to develop the assumptions for the SLM. Documentation should allow an informed reader or reviewer to understand the process of the procedures being executed, in order to diminish the potential of logic errors in the program's output.
4. FSA should coordinate with the Department, including Budget Service, to continue to develop detailed operating procedures for the loan estimation process, which would include the step-by-step procedures that take place during the various phases of the process.
5. Analytical tools should be developed to assure the splitter process, as described above, is operating as intended.

**2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)**

In connection with the annual audit of FSA's fiscal year 2004 financial statements, we conducted a controls review of the information technology (IT) processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.



**Report on Internal Control**

Page 6

The Office of Inspector General reported in the October 2004 audit report, *Department of Education's Implementation of FISMA – Fiscal Year 2004* (control number ED-OIG/A11-E0002), that the Department has made progress in addressing control weaknesses identified in prior audits. OIG has reported that the Department has made progress in several areas, including: finalizing system security plans, configuration management plans, and continuity/disaster recovery plans that support the agency-wide Information Security Program and Certification and Accreditation program; taking corrective action of security weaknesses reported in its Plan of Action and Milestones updates to OMB; assessing the viability of its Continuity of Operations and Business Continuity Plans; and implementing procedures for periodically testing and evaluating network level information security and implementing network intrusion detection systems.

Although progress has been made with respect to information technology controls, our work and the OIG findings reinforce that continuous effort is needed to further address control weaknesses related to information technology and systems. The OIG identified the Department's Certification and Accreditation process as a significant deficiency in its 2004 Federal Information Security Management Act (FISMA) report. The Department disagreed with the OIG's assessment of its Certification and Accreditation process. In particular, the following recommendations for improvements were noted for the Department and FSA:

- The Department's mission critical servers need to be consistently updated with the latest application version updates, virus/data integrity protection packages, and security patches.
- The use of complex passwords should be enforced on all systems across the enterprise.
- Network and host based intrusion detection systems should be deployed to provide meaningful alerts of potential network intrusions and malicious internal network activity.
- Access controls should be strengthened to protect certain mission critical systems.
- Configuration management processes can be improved to ensure consistent security configurations of servers across the enterprise and configuration settings.
- Technical security weaknesses identified in prior audits should be comprehensively reviewed to determine whether security controls have been fully implemented or adequately address the security weaknesses.
- The Certification and Accreditation process at the Department needs to be improved. Specifically, the Department should utilize security tools in determining whether system security weaknesses have been corrected and the Department should improve its oversight of contractors performing the C&A.

**Report on Internal Control**

Page 7

**Recommendation:**

We recommend that the Department continue efforts to address the security weakness identified by the OIG's FISMA report. Specifically, the Federal Student Aid should coordinate with the Department and implement actions to address the issues outlined above.

**STATUS OF PRIOR YEAR FINDINGS**

In the reports on the results of the fiscal year 2003 audit of the Federal Student Aid financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

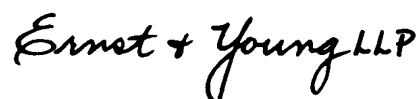
Figure 1: Summary of FY 2003 Reportable Conditions

Issue Area	Summary Control Issues	FY 2004 Status
Improvement of Financial Reporting Related to Credit Reform is Needed (Reportable Condition)	Management controls and analysis need to be strengthened over financial reporting related to credit reform.	Improvements Noted – Modified Repeat Condition Reportable Condition
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements Noted – Modified Repeat Condition Reportable Condition

We have reviewed our findings and recommendations with FSA management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 10, 2004.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.



November 10, 2004  
Washington, D.C.

## **Report on Compliance with Laws and Regulations**

To the Inspector General  
U.S. Department of Education

We have audited the consolidated balance sheets of the Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended, and have issued our report thereon dated November 10, 2004.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of FSA is responsible for complying with laws and regulations applicable to the entity. As part of obtaining reasonable assurance about whether the entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to FSA.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards or OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether FSA's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. FSA relies on the Department's systems to provide support for FSA's financial reporting needs, including utilizing the Department's general ledger to process transactions. We have identified the following instance of noncompliance:

**Report on Compliance with Laws and Regulations**

Page 2

The Department has made progress in strengthening controls over information technology processes during FY 2004. However, our work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses over information technology security and systems that need to be addressed. More specifically the Department should: (1) consistently apply updates, virus/data integrity protection packages, and security patches to mission critical systems; (2) enforce the use of complex passwords in all systems across the organization; (3) strengthen access controls to protect mission critical systems; (4) improve the configuration management process to ensure consistent security configuration of servers across the organization and improve configuration settings to comply with best practices; (5) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses; and (6) improve management and implementation of the Department's Certification and Accreditation process.

The Report on Internal Control includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and to the extent findings and recommendations were noted in prior years has provided a proposed action plan to the Office of Inspector General in accordance with applicable Department directives.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.



November 10, 2004

Washington, D.C.

# APPENDIX C

## PERFORMANCE DATA TABLES



## OBJECTIVE 6.4: STUDENT FINANCIAL ASSISTANCE PROGRAMS

<b>6.4.1 Student Financial Assistance programs will leave the GAO high risk list and will not return</b>	
<b>Fiscal Year</b>	<b>Actual</b>
2002	Completed 94% of the High Risk Plan
2003	The audit opinion is clean; SFA programs remained on the GAO high risk list.
2004	<b>The audit opinion is clean; the Department addressed 97% of audit recommendations and met integration goals in the FY 2004 FSA Performance Plan.</b>
We met our 2004 target of a clean audit opinion. We exceeded our 2004 target of completing 95% of audit recommendations. We met our integration goals in the FY 2004 FSA Performance Plan.	

FSA = Office of Federal Student Aid

SFA = Student Financial Assistance Programs

GAO = Government Accountability Office

**Source.** Department of Education, Office of Federal Student Aid (FSA) High Risk Plan and progress reports.

Independent Auditors' FY 2004 Financial Statement and Audit Report.

**Data Quality.** Independent auditors follow professional standards and conduct the audit under the oversight of the Office of Inspector General. In addition, internal quality control procedures are followed to ensure that the data are correct.

**Target Context.** The Government Accountability Office's (GAO) next release of its high risk list is planned for January 2005. The Department's targets are based on leaving the list as of January 2005.

**Additional Information.** The Department and FSA each received a clean opinion on their financial statements for FY 2002, FY 2003, and FY 2004. The clean opinions are important milestones in the Department's efforts toward creating a permanent culture of accountability and are crucial to FSA's efforts to have the Student Financial Assistance (SFA) programs removed from GAO's High Risk List.

GAO reviews the programs it designates as high risk on a biennial basis. The past assessment was conducted in FY 2002 with publication in January 2003. The most recent assessment opportunity occurred in FY 2004 with publication of the final report in January 2005. FSA has made considerable progress in FY 2004 in building on its foundation for management. Improvements have been made in financial management, in program integrity, and in the strategic management of human capital. In addition, FSA is improving its management of information technology resources to improve services

for customers and partners and is moving forward with its modernization of its programs to improve their integrity. FSA has worked with GAO staff to ensure that they are informed of our progress toward resolving Department management issues and sustaining improvement in our programs.

<b>6.4.2 Default recovery rate in percent (percentage of FSA's collections, excluding consolidations)</b>	
<b>Fiscal Year</b>	<b>Actual</b>
1999	8.0
2000	7.5
2001	7.8
2002	7.6
2003	9.5
2004	<b>10.1</b>
We exceeded our 2004 target of 9.5.	

FSA = Office of Federal Student Aid

<b>6.4.3 Overall default recovery rate (percentage of FSA and GAs' collections excluding consolidations)</b>	
<b>Fiscal Year</b>	<b>Actual</b>
2004	<b>11.2</b>
We exceeded our 2004 target of 11.0.	

FSA = Office of Federal Student Aid

GAs = Guaranty Agencies

This measure was first established for FY 2004.

**Source.** Department of Education, Debt Collection Management Systems (DCMS) Management Information System (MIS) reports.

**Data Quality.** Internal quality control and auditing procedures are followed to ensure that the data are correct.

**Target Context.** Targets are based on trend data and performance measures established for private collection agencies providing debt collection services to the Department.

6.4.4–6.4.6 Percentage of Pell Grants erroneous payments			
Fiscal Year	Overpayments	Underpayments <sup>1</sup>	Erroneous Payments <sup>2</sup>
2001	3.4		
2002	3.3		
2003	3.1		4.9
2004	2.8	1.8	4.5
	We did better than our 2004 target of 3.1.	We met our 2004 target of 1.8.	We did better than our 2004 target of 4.9.

<sup>1</sup>This measure was first established for FY 2004.

<sup>2</sup>This measure was first established for FY 2003.

**Source.** Analysis of sampled Internal Revenue Service income data compared to data reported on the Department of Education’s Free Application for Federal Student Aid (FAFSA) reported by the Office of Federal Student Aid (FSA) and the Common Origination and Disbursement (COD) system.

**Data Quality.** The overpayment measure is determined by dividing the estimated dollar amount of overpayments by the total dollar value of Pell Grants awarded in academic year 2003–04. The underpayment measure is determined by dividing the estimated dollar amount of underpayments by the total dollar value of Pell Grants awarded in academic year 2003–04. The erroneous payments measure is determined by totaling the dollar amount of estimated overpayments and underpayments and dividing by the total dollar value of Pell Grants awarded in academic year 2003–04.

Overpayment and underpayment percentages are rounded. The actual percentage for overpayments is 2.75 percent, and the actual percentage for underpayments is 1.75 percent.

**Target Context.** Targets are based on trend data and were established in an effort to meet the governmentwide target of 2.5 percent. However, until FSA has the statutory authority to use IRS data matching, the governmentwide target of 2.5 percent cannot be met.

**Related Information.** Information on the Improper Payments Information Act of 2002 can be found at <http://www.whitehouse.gov/omb/memoranda/m03-13-attach.pdf>.

**Additional Information.** Based on recent estimates, federal agencies make more than \$35 billion in improper payments each year. An improper payment occurs when federal funds go to the wrong recipient, the recipient receives the incorrect amount of funds, or the recipient uses the funds in an improper manner. Eliminating such payments is central to efforts to improve financial performance governmentwide, enhance the integrity of federal programs, and ensure that limited federal resources are used for their intended purpose. The Improper Payments Information Act (IPIA) of 2002 establishes a framework for improved

performance on the measurement and reduction of improper payments.

FSA has implemented numerous strategies for reducing erroneous payments in the Federal Pell Grant Program. We continue to use applicant data from the Central Processing System (CPS), Pell payment data from the Common Origination and Disbursement (COD) system, and IRS data to refine and improve our verification selection criteria to better identify applicants who are likely to have made income-reporting errors on their Free Application for Federal Student Aid that would result in significant overawards in the Pell Grant Program. In addition, we continue to review management information system reports, as well as customized queries of the Central Processing System, to identify and analyze fields on the application that are frequently corrected and, therefore, potentially most error prone. In combination with these efforts, we continue to conduct usability testing on the application form to identify questions that applicants and their families have difficulty understanding. These questions have been reworded on the 2004–05 application to be clearer and, therefore, easier for applicants to answer accurately. We have also added additional logic to our Web applications that is designed to detect and point out to applicants potential mistakes before application data are transmitted to the Central Processing System. FSA has also taken additional steps to inform students and parents who estimate income information on the application that they must compare their answers to their tax returns once they have completed them and to promptly make any necessary changes to their application data to avoid losing or having to repay federal student aid they have received. In May 2004, FSA sent approximately 250,000 e-mail notices to student aid applicants (and their parents) who indicated on their applications that the income information they provided was estimated. The e-mails asked students and parents to update their application income information if it was different than what they reported on their income tax returns. In 2005–06, FSA will expand this initiative to include many more applicants and parents (several million) and will also put in place a system for analyzing the effectiveness of this initiative. We are also continuing to work with OMB and Treasury in support of proposed legislation to revise the IRS Code to authorize the matching of Title IV FSA

applicant data to tax return data. In preparation of the passage of this legislation, the office has begun the evaluation of five possible approaches for implementing an income verification match. FSA has ranked the evaluation of the five approaches using several criteria, including overall risk to successful implementation, cost, and customer satisfaction. Once legislation passes, FSA will be in a good position to begin discussions with IRS to implement an income verification match.

6.4.7 Timeliness of FSA major system reconciliations to the general ledger, expressed as the number of days after month-end close	
Fiscal Year	Actual
2002	45
2003	Oct–Mar: 35 days Apr–Sept: 24 days
2004	<b>19 days</b>
We did better than our 2004 target of 30 days.	

FSA = Office of Federal Student Aid

**Source.** Department of Education, internal system reports.

**Data Quality.** The FY 2004 data are an average based on data from September 2003 through August 2004. Internal quality control and auditing procedures are followed to ensure that the data are correct.

**Target Context.** The Department aligned its target with the governmentwide accelerated audit reporting requirements. Federal agencies must finalize their financial audit statements within 45 days of year-end.

**Additional Information.** In FY 2004, the Office of Federal Student Aid (FSA) never exceeded the 30-day target. On average, major accounts were reconciled within 19 days.

6.4.8 Number of material weaknesses and reportable conditions in FSA financial audit statements	
Fiscal Year	Actual
2000	4
2001	3
2002	2
2003	1
2004	0
We did better than our 2004 target of 1.	

FSA = Office of Federal Student Aid

This measure was first established for FY 2004.

**Source.** Independent Auditors' FY 2004 Federal Student Aid Financial Statement and Audit Report.

**Data Quality.** Independent auditors follow professional standards and conduct the audit under the oversight of the Office of Inspector General.

**Target Context.** The Office of Federal Student Aid has made a concerted effort over the last several years to reduce the number of recommendations made in the

financial statement audit and to implement the audit recommendations from prior year financial statement audits. The targets reflect efforts to date and trend data.

**Related Information.** The *FY 2003 Performance and Accountability Report* is available at <http://www.ed.gov/about/reports/annual/2003report/index.html>.

The *FY 2004 Performance and Accountability Report* is available at <http://www.ed.gov/about/reports/annual/2004report/index.html>.

**Additional Information.** Although this performance measure was established for the first time in FY 2004, the number of material weaknesses and reportable conditions from prior FSA financial audit statements is included for reference.

6.4.9 Integration of FSA processes and systems that work together to support FSA program delivery functions	
Fiscal Year	Actual
2002	100
2003	Met 100% of the targets in FSA's sequencing plan; updated integration plan through the data strategy effort.
2004	<b>Met 100% of targets in FSA's sequencing plan.</b>
We met our 2004 target of achieving 100% of the targets in FSA's sequencing plan.	

FSA = Office of Federal Student Aid

**Source.** Department of Education, internal Office of Federal Student Aid (FSA) progress reports.

**Data Quality.** Internal quality control and auditing procedures are followed to ensure that the data are correct.

**Target Context.** Targets are based on work plans to support FSA's sequencing plan.

**Additional Information.** FSA's sequencing plan enables FSA to make changes to operations, systems, and contracts without adversely affecting day-to-day operations. The sequencing plan identifies milestones for activities that will be completed each fiscal year.

FSA has made considerable progress in furthering its integration goals. Notable accomplishments for FY 2004 include the following:

- Implemented Phase One of Common Services for Borrowers (CSB).
- Continued development of Enterprise Data Strategy.
- Implemented a pilot for the Standard Student Identification Methodology (SSIM).
- Implemented the Institutional Student Information Record (ISIR) Data Mart.



- Implemented Forms 2000 enhancements.
- Developed FSA Security and Privacy Architecture pilot.
- Developed Performance Test Architecture to certify new applications or enhancements to applications for deployment in the Virtual Data Center.
- Awarded a contract to perform the conceptual design and development of the Integrated Partner Management (IPM) Solution.
- Supported the implementation of Oracle Federal Financials Release 11i.

6.4.10-6.4.13 FSA Customer Service (measures of service levels of targeted FSA transactions with public)				
Fiscal Year	FAFSA on the Web	Direct Loan Servicing	Common Origination and Disbursement (COD)	Lender Reporting System (LaRS)
2003	86	77	66	71
2004	81	78	72	73
	We did not meet our 2004 target of 86.	We exceeded our 2004 target of 77.	We exceeded our 2004 target of 70.	We made progress toward meeting our 2004 target of 74.

FSA = Office of Federal Student Aid

FAFSA = Free Application for Federal Student Aid

**Source.** FY 2004 American Customer Satisfaction Index (ACSI) survey.

**Data Quality.** ACSI is indexed from 1 to 100. ACSI provides a national, cross-industry, cross-public, and private sector economic indicator produced by a partnership of the National Quality Research Center (at the University of Michigan Business School), CFI Group, and the American Society for Quality. The ACSI uses a widely accepted methodology to obtain standardized customer satisfaction information.

**Target Context.** Targets are based on trend data.

**Additional Information.** Every year the Office of Federal Student Aid (FSA) conducts customer surveys of its most high-profile, highly used products and services: FAFSA on the Web, Direct Loan Servicing, Common Origination and Disbursement, and the Lender Reporting System.

FSA's ACSI scores (indexed from 1 to 100) are generally good and are in the range of national benchmarks including the national ACSI average score of 74, the federal agency average score of 71, and the banking industry average score of 75.

*FAFSA on the Web* is the Web-based product that applicants complete to determine their eligibility for federal student aid. In FY 2004, about 10.8 million out of a total of 13.5 million applications were filed electronically with slightly over three-quarters using FAFSA on the Web. The FY 2004 FAFSA on the Web ACSI score dropped to an 81 from last year's 86. Customers are reporting lower satisfaction levels across most of the FAFSA on the Web service components; however, some of the biggest changes noted are in customer comparisons of the current service to an "ideal" and "to their expectations." These two factors

are critical components in the calculation of the ACSI score. We believe as users continue to become more and more familiar with Web-based applications, we will continue to experience some challenges in these areas. However, FSA plans to further analyze the results of the survey and look for additional opportunities for improvement.

Although our score has declined, the FAFSA on the Web remains a highly rated product, exceeding the scores of the national benchmarks noted above and is on par with the highest rated products within ACSI's E-commerce Index. Additionally, FAFSA on the Web remains one of the highest rated E-government Web sites. In ACSI's recent E-government survey released in September 2004, only three agencies report higher scores than FSA's FAFSA on the Web and no other e-government Web site in the e-Commerce/Transaction Index reported a higher score.

*Direct Loan Servicing* is the process by which loans are repaid and includes the issuing of monthly statements; collecting of loan balances; and offering customer-service help and web-based help and information. The Direct Loan Servicer is handling about 6.6 million borrower accounts. The FY 2004 Direct Loan Servicing ACSI score is 78, up one point from last year's score of 77. Customers using the electronic debit capabilities to repay their Direct Loans, as well as those receiving paper statements, report extremely high levels of satisfaction with those processes; however, the automated voice response services are rated significantly lower. The ACSI has noted low automated voice response results in many of the industries it measures.

*The Common Origination and Disbursement (COD)* system is the mechanism that schools use to receive and account for federal funds used in the Direct Loan and

Pell Grant Programs. More than 5,200 schools participating in the Pell and/or Direct Loan Program used the COD during FY 2004. Altogether, \$25.9 billion in loans and grants were processed through the system. The FY 2004 COD ACSI score of 72 is up six points from last year's 66, and it exceeded the goal of 70 that was set by FSA's Management Team. Specifically, customers noted large improvements in our ability to help them with inquiries and with the accuracy of our data.

*The Lender Reporting System (LaRS)* is the mechanism that lenders and servicers use to receive interest and

special allowance payments from the Department on their active Federal Family Education Loan (FFEL) Program loan portfolios. Approximately 3,500 lenders and or their servicers use the LaRS. The overall ACSI score for LaRS is 73, up two points from last year's 71, and just one point shy of FSA's goal of 74. While we continue to receive high marks for our LaRS technical assistance, customers report some issues in navigating the system and in making corrections to previously reported data. The office plans to further analyze the results of the survey and look for additional opportunities for improvement.

